Vision vs. Reality

FOUNDERS CAPITAL MANAGEMENT
2023 ANNUAL REPORT

Investing for the Long Term. Every Day.

An innovative money management firm investing in publicly traded equities and fixed-income securities. A deep base in business management with a truly global perspective. A drive to identify true fundamental value. A commitment to buy carefully and hold for the long term. A passion to provide customized investment solutions tailored to each client's financial goals and risk tolerance.

This is Founders.

Founders Capital Management, LLC

2023 Annual Report:

"Vision vs. Reality"

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2023 PRINCIPALS' LETTER
From: Founders Capital Management

"Vision vs. Reality"

"It ain't what you don't know that gets one in trouble.
It's what you know for sure that just ain't so."
— Mark Twain

Although the stock market ended 2023 near record highs, it was hardly a year without turmoil. In fact, the only consistent aspect of the stock market the past three years might be the types of adjectives investors have used to describe their experiences—"instability," "chaos," "confusion," "mayhem." On several occasions during the past three years, market disruptions compelled us to issue client communications outside of our annual letters—a rare occurrence over the past 20 years. We felt it necessary to issue special communication letters in March 2020 due to the COVID crisis; in August 2022 due to sudden increases in interest rates by the Federal Reserve; and in the first quarter of 2023, when the banking system faced tremendous stress as billions of dollars in deposits were precipitously removed from small and mid-size banks, leading to "runs" on certain banks. Five banks collapsed, and it took a coordinated effort between the FDIC and Federal Reserve to protect depositors and the banking system from additional potential failures.

How did we get here?

At the start of the COVID pandemic in 2020, the Federal Reserve aggressively lowered interest rates, and the U.S. government issued money to individuals, families, and businesses to provide the economy with liquidity during a time that it had become idle and faced an inactivity crisis that could have led to long-term economic stagnation—essentially, flooding money into the market to enable everyone to weather the immediate economic crisis. Pumping excess money into the economy may have prevented a temporary crisis from creating long-term damage, but it drove an unexpected consequence: Investors became speculators, using government-issued funds and low-cost borrowed money to gamble in the stock market. As the economy gained footing, the stock market shot up, low interest rates incentivized borrowers, and several government-sponsored programs to place money in the hands of citizens eventually resulted in too much money chasing too few goods, leading to inflation.

Throughout 2022, the Federal Reserve rapidly increased interest rates to stem growing inflation, and our financial system began to experience greater stress. The stock market fell precipitously throughout that year as money was rapidly removed from the market and the economy. At the beginning of 2023, when financial firms reported their earnings for the previous year, it became apparent that many were gasping for air. (The flow of money in financial institutions is similar to breathing air—it is taken for granted until it's not available.) As interest rates increased, banks that had chosen to expose themselves to long-term investments in secure bonds within their securities portfolios watched the value of those bonds deteriorate faster than any stock. When banks reported their year-end 2022 earnings to investors, it became glaringly clear that the bonds were worth much less than they had been at the time of their purchase, when banks had to "mark" a large portion of these securities at the current lower value. The financial stress this caused among many banks was noticeable—the long-term investments that had become permanently impaired impacted the capital buffer these financial institutions

needed to “breathe” and remain viable in the future. Depositors panicked and began removing their money in droves from the most exposed banks.

The ongoing actions of the Federal Reserve likely averted damage to our economic system. It is apparent now, however, that the days of near-zero interest rates and loose monetary policies that allow money to stay within the financial system are over. Investors now need to temper their expectations of high future market returns and their hopes of achieving double-digit returns over the next 10 or more years.

Against this backdrop, our 2023 letter will focus on the question: Should a person considering investing in a company focus on a vision of its future, its reality today, or both?

When choosing a company in which to invest, many individuals base their decision on a vision they have formulated about the company’s future. The “story” they have developed could be about a company envisioned to produce a dominant share of all energy-efficient automobiles in the future, or one that will take a leading role in developing artificial intelligence (AI) in the future, or one that will usher in a future of novel mRNA drugs. Notice the key word in all these stories: “Future.” A vision of a company’s future can drive investment behavior—both beneficially and detrimentally.

An investor focused more on a company’s reality, on the other hand, is all about “show me now:” Show me the relevant financial metrics of a business today that are expected to continue. The reality may mean that the pioneering automobile, AI technology, and mRNA drug development companies make little or no money today and could have very low chances of being profitable in the future.

Where should an investor’s focus fall about a given company within this vision-reality spectrum? This is the overarching question we will ponder in this year’s letter.

A Short Tale: “This is the Stock Market”

> In a bustling pub named “The Bull and Bear,” two investors sit locked in a passionate debate. One, a staunch fundamentalist, dissects businesses with surgical precision before investing a single penny. The other, a technical trader, prioritizes market trends, chasing chart patterns and momentum-trading. Their heated exchange sparks a profound question: Can anyone truly own a piece of a company amid the stock market’s chaotic dance?
>
> The technical trader scoffs: “It’s not like I don’t ever use valuation to assess a stock choice. Just last month, I got caught in a difficult stock trade during a severe market downturn, and everything became unclear as I watched my stock plummet like a stone. I was overcome with panic, thinking I was headed for a financial disaster. I couldn’t see any trends, and I was losing money quickly, and so I tried it—I studied the company I had traded into, focusing on its business value, assessing profitability, comparing it to its competitors, and evaluating its position in its industry. I decided to stick with the trade, and finally the stock soared.”
>
> The fundamentalist, sensing an opening, retorts, “Surely, you now see the value of understanding a company’s true worth?”
>
> A cynical look comes to the trader’s face. “What? Long-term interest rates dropped, that’s all. The market is always a fickle beast. It went up after the Fed announced a hold on raising interest rates—and my stock skyrocketed. Then I sold the position for a profit and went on to the next trade.”

This exchange exposes a fundamental truth: Individuals with different perspectives can interpret the same experience in vastly different ways. But what drives these contrasting interpretations? Where do these beliefs originate?

Are our inclinations about the market inherently hardwired, or are they shaped by our upbringing, biases, and life experiences? Perhaps our investment philosophies are as deeply ingrained as our eye color or fingerprint. If so, then achieving investment success transcends mere knowledge acquisition. It demands rewiring our “default settings” and untangling the emotional web that can trap us in a cycle of acting based on fear and greed.

As market participants, we are constantly bombarded with external stimuli. The ticker tape scrolls with frantic urgency as pundits preach their borrowed wisdom. This relentless noise amplifies the true battleground—the battle in our own minds. When facing price volatility, our inner voice floods with anxieties and urges, drowning out rational thought.

It doesn’t have to be that way. Stock market participants can consciously choose to be present, to quiet the mental chatter, and to see price gyrations not as threats but as data points that represent opportunity. Investors can choose to care about

the businesses they own, not just the numbers on the screen. This is the essence of "owning one's mind" in the market. It's not about being a soulless robot or a permabull. It's about practicing conscious awareness. One can acknowledge the emotional tug-of-war within but refuse to be its puppet. Market participants can be the authors—not the leading characters—of their internal market narratives.

It is difficult to overcome or ignore one's unconscious default settings. In fact, Wall Street preys on this and does not discourage market participants from operating on their default settings, because the world of money and power thrives on manipulating investor fear and greed. Investors who "own their own minds" pose a significant threat to Wall Street—by remaining present and emotionally detached, these market participants refuse to be pawns in the "Wall Street game." Their practice of self-awareness empowers them to dictate their own investment journey that is free from the manipulation that fuels the market's chaos. This is how successful investors separate themselves from the Wall Street herd.

My 45 years in the trenches have shown me that a true market education goes beyond learning "how to think" about the stock market, e.g., mastering trading patterns or business valuation. It's also about mastering the art of self-awareness, and of controlling how and what we think. This is the true test, the ultimate challenge: Mastering the market within.

Market participants may believe themselves to be rational beings, but even the most seasoned traders betray their anxieties when facing a plummeting stock. Fear and doubt creep in, clouding judgment. This is the paradox of the market: It beckons us with the promise of logic, then blindsides us with emotion.

Ultimately, success in the stock market hinges on our overarching ideology: Do we choose to "rent a business," engaging in fleeting flings that we change regularly with the market's whims? Or do we opt to "buy to own," forging a long-term bond with a company's soul and potential?

The "buy to own" approach requires discipline, patience, and a willingness to understand— not banish—our emotions. It's about recognizing that the mind can be either "an excellent servant or a terrible master." We must choose to serve our long-term goals, not our emotional impulses.

In conclusion: Success in the stock market isn't about technical wizardry or market-beating strategies. It's about the quiet power of self-awareness, the ability to step back from the ticker tape and ask: "Which voice am I listening to? My fear, or my reason?"

* * *

In recent letters, we pointed out how the stock market has become more schizophrenic. Looking back over the previous five years: The S&P 500 experienced a sudden 16% nosedive during a three-week period in December, 2018, followed by a market recovery over the next 14 months that led to a 44% increase in the S&P 500 by the first quarter of 2020. Just when everything looked rosy again, the index did a 34% freefall in just 33 days due to the sudden emergence of COVID-19. After this precipitous drop, the S&P 500 rose a stunning 67% by the end of 2020. Based on this rapid recovery, market forecasters predicted that the market would struggle in 2021—wrong. The market had a surprising rise during 2021, with the S&P 500 ending up with a 28.7% gain for the year. Just when everyone was positive about the economy and market, in 2022, the S&P 500 and Nasdaq suffered surprising losses of 19.4% and 32.5%, respectively, as the Fed aggressively raised interest rates to stem high inflation. Market turmoil continued during the first three months of 2023 due to a short-term banking crisis but recovered by December 31st—resulting in a 24.2% gain in the S&P 500 for the year.

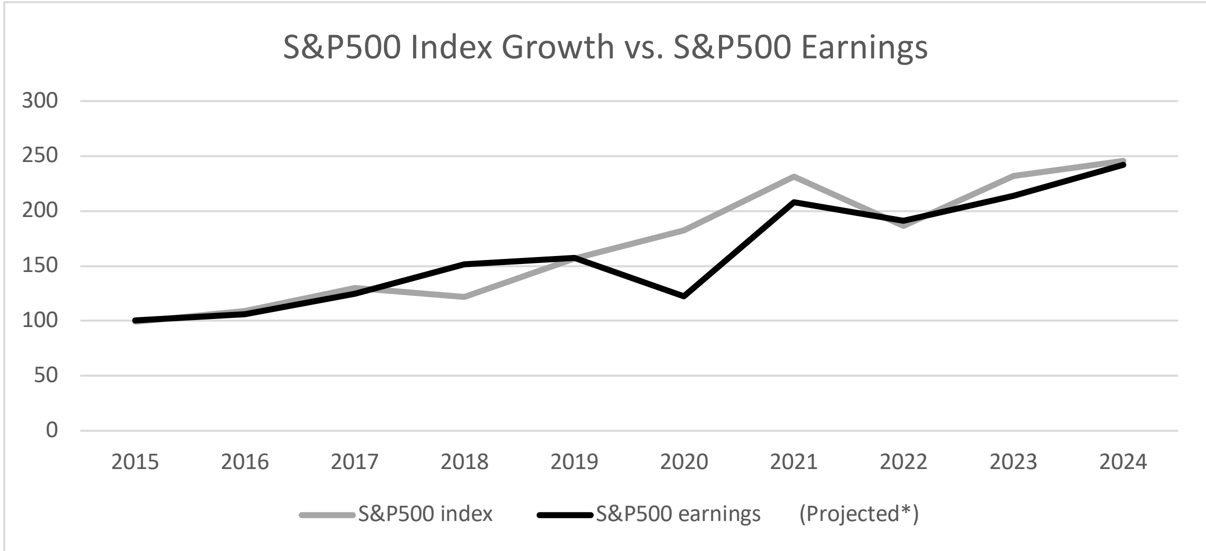
In short: The stock market has been extremely inconsistent over the past few years, a wild roller coaster ride that continues to leave its riders nauseous—and more convinced than ever that the stock market (and now, the fixed income market) is essentially a casino in which every participant is betting on short-term wins. The "gambling mentality" that has taken hold of market participants in recent years has damaged the previously implicit "contract" among even professional investors that markets should be used as a mechanism for investing, not speculating.

In 2023, as many investors likely wondered if being involved in a gambling casino called the stock market is worth the pain, overall investment sentiment continued to be a revolving door—turning from enthusiastic optimism to unchecked pessimism and back to enthusiastic optimism. So what's next? In 2023, we watched investors chase short-term gains through the purchase of companies involved in artificial intelligence (AI) and

electric vehicles (EVs). Assessing the value of these companies, or clarity about their future, seemed to have little bearing on investment decisions. As a result, many of these companies that reside in the Nasdaq 100, which had been punished with a large loss of approximately 33% in 2022, experienced a large recovery in 2023—the Nasdaq 100 was up 53.8% this past year.

Let's revisit a warning we've stated in the past: **Speculative behavior will end some day and badly impact the markets—we just don't know when.** Speculative behavior ended in 2022 and badly impacted the markets, and many good companies in the affected technology, communication, and social media sectors were unfairly impacted as a result. And therein laid the opportunity, as several long-term businesses traded at extremely low valuations (and low prices). Many of these businesses—some of which we own—recovered in price over 2023, and now they are trading within a range of their fair value. We expect their future values to stay more in line with growth in their intrinsic business values, as opposed to reflecting arbitrary increases in their stock prices.

Despite the erratic recent behavior of the stock market, we will once again step back and evaluate the longer-term trends. The following update to the chart we have presented in previous years assesses gains in price vs. earnings for the S&P 500 since 2015:



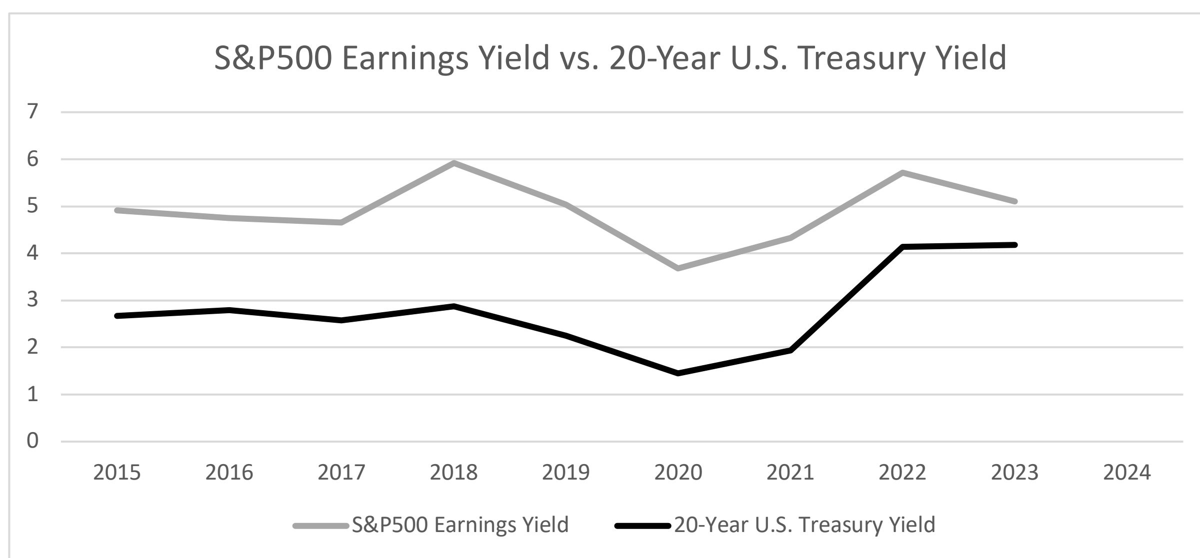
If we had placed $100 in the S&P 500 at the beginning of 2015, that investment would have turned into approximately $231.65 at the end of 2023—reflecting an annual return of approximately 9.78% over nine years. Now, let's assume (we're not predicting—this is just an illustration) that, given that 2023 was a banner year, the S&P 500 index conservatively grows in price during 2024 by half its expected aggregate company earnings growth. In this scenario, an investor's 10-year annual return would adjust to approximately 9.4% at the end of next year. This assumes, however, that interest rates remain at their current level (a big disclaimer). In an environment of ever-increasing interest rates (due to persistent inflation) that acts as an anchor weighing down all invested assets, the markets could remain pressured in the upcoming year. At the time of this writing, however—given the market's recent rise—investors are expecting short-term interest rates to steadily decline next year compared to where they ended in 2023.

As a comparison, if we look at the growth in operating earnings for all companies in the S&P 500 over the same nine-year period, the S&P 500's collective operating earnings would have grown from approximately $100 to $214 per share by the end of 2023—representing an annual increase in S&P 500 operating earnings of around 8.8%. If the expected operating earnings for the S&P 500 grows to $245 in 2024, the annual growth in operating earnings would turn out to be approximately 9.4% over a 10-year period—equal to the growth in the S&P 500 index in our outlined scenario. Again, rising interest rates associated with inflation lower the future

value of S&P 500 earnings, even though companies continue to grow—thus, the market can continue to undergo pressure if inflation persists.

The key point: Although the S&P 500 index's extreme price gyrations over the years resulted in drops and surges in excess of 25%, our presented case shows that the aggregate companies that make up the stock market index continue to grow their earnings over time, and the eventual price of the market index is a reflection of these companies' expected earnings. Investors should understand, however, that the price of the market index reflects today's assessed value of all its companies' future earnings that are expected to be discounted by an interest rate that is largely impacted via inflation. The higher the expected inflation, the greater these future earnings will be discounted, negatively impacting the price of all assets.

Let's introduce a new chart that has relative importance when evaluating the stock market index price:



In general, investors have a choice to place their funds in either the stock market index or the fixed-income index. A well-known classic investment strategy from financial advisors suggests allocating 60% of one's portfolio to stocks and 40% to bonds. This general strategy is designed to provide a balance of risk and return, and it has been a popular choice for investors over many years. In theory, the 60/40 portfolio represents a diversified portfolio—one that spreads investments across different asset classes (traditionally, stocks are considered to be riskier than bonds but have the potential for higher returns, while bonds are considered to be safer than stocks but have the potential for lower returns). The 60/40 portfolio represents a disciplined practice of maintaining consistent diversification to reduce overall investment risk, with potential losses in one asset class offsetting potential gains in the other. Over time, many financial advisors have come to tailor this general strategy to one's age—for example, a 30-year-old who has decades of investment life ahead would be advised to maintain a 90/10 portfolio with stocks heavily weighted, whereas an 80-year-old who has a more limited investment life left would be advised to maintain a 40/60 portfolio with bonds heavily weighted.

This investment strategy is all well and good during "normal times"—but, unfortunately, we have not been in normal times. An 80-year-old who felt wary of the stock market and decided to conservatively place 100% of his money in the general bond index for the past three years would have experienced a cumulative loss in price of approximately 9.5% on his portfolio. Over the same three-year period, a general investment in the stock market index (S&P 500) would have achieved a cumulative gain in price of approximately 27.5%—despite the market's greater volatility.

The primary issue with historical general investment formulas is their application, which is meant for a normal disparity between the yields offered between an investment in the general stock market vs. in the general bond

market. The chart above shows that the investment yield offered on a 20-year U.S. Treasury bond was 2.87% in December 2020, while an investment in the S&P 500 index at the same time offered an earnings yield of 5.92%. Any investor looking at this point in time would deduce that earning 5.92% on an investment in the general stock market is better than earning 2.87% on an investment in a 20-year U.S. Treasury bond. Unfortunately, many investors shaken by the stock market's recent volatility made the mistake of running to place a disproportionate share of their money into long-term government bonds.

The chart above reflects the comparative yields offered on an investment in the S&P 500 vs. a 20-year U.S. Treasury bond at the end of each year since 2015. Clearly, from 2015 through 2021, investing in the S&P 500 index yielded superior gains relative to an investment in a 20-year U.S. Treasury bond, thus favoring a portfolio weighted toward the general stock market. It is also important to notice today that the earnings yield on the S&P 500 is closer to the yield on a 20-year U.S. Treasury bond—in other words, investments in fixed-income investments are becoming more attractive as interest rates have risen quickly over the past 21 months.

The important point: It is natural for investors seeking to obtain the highest-yielding returns on their allocation of money to compare the different asset classes available: When there is a large disparity between the investment yields of different asset classes, investors (especially professionals) magnetically gravitate toward placing a greater amount of capital in the highest-yielding investment class—regardless of what history might suggest as allocation weights by financial advisors that are based on past interest rate disparities between the yields offered on an investment in the general stock market vs. in the general bond market.

A final point: In managing a stock portfolio, it is advisable to treat a collection of stocks as if they were one aggregated company. This involves constantly comparing one's collective stock portfolio to the stock market and fixed-income averages. For example, at Founders, our collective stock portfolio at the end of 2023 has a forward earnings yield of 5.4% that is growing at around 10% per year. This compares to an S&P 500 forward earnings yield of 5.1% that is growing at 8% per year and a 10-year U.S. Treasury bond yield that is currently at 3.9%. In addition, the approximate return on average equity for Founders' aggregate portfolio is around 25%, compared to the aggregate return on equity for the S&P 500 of around 17%.

We strive to maintain, with a degree of certainty, the highest-yielding stock portfolio while maximizing the returns on capital, which will grow a bit faster than overall comparative yields available in the general stock and bond markets. In light of this, we have taken advantage of placing large amounts of dormant funds into short-term (less than one-year), risk-free U.S. Treasury bills that have been offering annualized yields as high as 5.3%—a much higher investment yield compared to a 10-year U.S. Treasury bond.

Let us return to this letter's focus: How do we proceed from here? Should a stock market participant evaluating a company for investment focus on a vision of its future, its reality today, or both?

The Art of Visionary Investing & The Science of Reality-Based Investing

In the past, we have discussed how our minds are wired naturally, through evolution, to be constantly aware of our surroundings to protect us from danger—leading to stress responses such as fight or flight, aggression, etc. Although our response to danger can be similar to that of an animal, there is a key difference: In addition to our instinctual "animal" response, humans engage in complex cognitive processes such as risk assessment and decision-making when confronting perceived danger. Our cognitive processing is highly influenced by what we have experienced in the world, and we all have a "stream-of-consciousness" internal voice continuously talking to us. This voice becomes extremely active when a buildup of anxiety, fear, desire, love, etc. occurs, and it is difficult to tame. This same voice collectively experienced by a crowd of investors can underpin short-term gyrations in the stock market.

When we combine our natural continuous, unedited flow of thoughts with our inclination to complete a story (or to forecast the future) and our mixed emotions, biases, and desires, we end up with some crazy combinations. To illustrate: Imagine a father on the occasion of his daughter's first date with a boy she "really likes." She says she is "just going out for pizza" and will "be back home in a few hours." The boy pulls into the driveway in a brand new car. He's handsome and confident, and he steps out slickly to greet Daddy's baby

girl. During introductions, the father learns that he is three years older than his 16-year-old daughter. He quickly asks, “So where exactly are you going—just pizza? Will you be home in an hour?” Rolling her eyes, the embarrassed daughter delivers the “old-man” look and gets into the car. The father can see that she is thinking, “Doesn’t he trust me?” Of course, the issue is not about trust; rather, a hypothetical “innate story” has quickly developed in the father’s mind, fueled by his emotions, a mix of biases (perhaps including hindsight bias—i.e., “I’ve seen this before”), and a desire to ensure his daughter’s safety and happiness. The father wants to protect his daughter from the potential experience of being hurt by a boy she likes a lot.

The innate “voice in our head” and the natural inclination to “complete a story” take place throughout our lives and are pronounced when we place money in the stock market. For example: Let’s say that an individual hears about an opportunity to buy a stock through a friend that appears to be very knowledgeable. The friend passes on a “tip” that stock in ABC Co. is a once-in-a-lifetime opportunity, explaining that the company is positioned to dominate the future of automobile sales through its electric vehicles that feature a patented, long-lasting battery as well as proprietary computer and software technologies that enable self-driving. In addition, other businesses will spin off from this company’s genius founder. He takes his friend’s advice and buys the stock. It goes up a lot, and he becomes emotionally attached, wanting to buy more no matter what the price. Listening to positive stories about this company and its founder while watching others flock to the stock confirms his choice to place a large part of his wealth in ABC Co. Looking at a stock chart, he envisions a continuous upward slope growing to the stars while dreaming about how he is going to spend a newfound fortune.

We examined in the past how even geniuses fail because of investment storytelling. Mark Twain (whose real name was Samuel Clemens) was one of the greatest storytellers in history, but his investment adventures could be likened to rafting down the Mississippi River with the hope of finding riches, only to experience nightmares brought on by speculation. He stated to his friend and fellow novelist, William Dean Howells, “I must speculate in something, such being my nature.” Speculate he did—gossiping with Wall Street traders for hot tips, he purchased companies such as Denver & Rio Grande Railway, South African diamond mines, and the Independent Watch Company—which all failed. He placed $23,000 into the Hartford Accident Insurance Company, which went bust in less than two years. Acting once again on a “tip,” Samuel Clemens bought $21,000 of the Oregon & Transcontinental Company on margin—borrowing money to purchase the stock. As the O&T Railroad went down in price, he bought more. After losing almost 80% of his money, he instructed his nephew to figure out whether to sell or hold the stock, stating that he “didn’t wish to ever look at a stock report again.” He sold his position in O&T Railroad—which eventually went bankrupt—losing more than $18,000. Sam also put money into the New York Vaporizing Company—and watched his investment vaporize almost instantly.

Samuel Clemens was a literary genius but a hapless player in the stock market. He was incapable of resisting any stock that provided him with a good story that would turn into a winning lottery ticket. He ended up calling margin “mud,” brokers “stock meddlers,” and executives at companies “chartered robbers.” He lost a fortune in the stock market, as well as in several business ventures that were intended to make him insanely wealthy.

Another genius—Isaac Newton—lost his fortune after investing nearly 100% of his wealth in South Sea Company stock, a company through which the English government provided exclusive trading rights with Spanish colonies in South America. Investors throughout England passed along a story of how this company’s monopoly trade arrangement in the South Seas would lead to Mexico and South America enthusiastically trading tremendous amounts of gold and jewels in exchange for wool and fleece clothing made in England.

Initially, Isaac placed £7,000 in South Sea Company stock; this quickly doubled, providing him with a 100% profit. He sensed that the risk in this stock was too high and decided to take his money completely off the table. He said, "I can calculate the motions of the heavenly bodies, but I cannot calculate the madness of people." The ironic part of Isaac’s risk assessment is that, shortly thereafter, as he nervously watched the stock price climb from the sidelines, he decided to jump back into the action. He went all in, placing all his money into the South Sea Company, and then watched the stock nosedive, taking most of his fortune—the equivalent of more than $10 million today—with it. Newton reportedly was so angry about his losses that he never wanted to hear the name of the South Sea Company again.

After hearing these stories about Mark Twain and Isaac Newton, one may conclude that envisioning a story about a company's potential future should not play any part in evaluating a potential investment in a company. A large portion of any company's valuation is based on an assessment of its future prospects, however, and so developing a "story" envisioning the company's future is usually necessary.

The Visionary Investor

In the world of investing, a sea of data and financial projections can often obscure the true essence of a business. While numbers can provide valuable insights, it is often the visionary investors who have a keen understanding of a business' fundamentals and a strong grasp of its potential who uncover the hidden gems amid the stock market noise.

Warren Buffett, who most believe is a "hard numbers" investor, is actually the epitome of a visionary investor. He once remarked, "The best way to predict the future is to create it." Mr. Buffett's philosophy underscores the importance of an investor's vision in shaping the trajectory of a business. Visionary investors don't merely analyze past performance and project future earnings; they possess the ability to envision how a company is positioned to transform and evolve, outpace competitors, and shape and adapt to an ever-changing industry landscape.

A visionary investor's insight is not created out of thin air through storytelling; it is rooted in a deep understanding of business dynamics, market trends, and consumer preferences. These types of investors have the ability to "connect the dots" between seemingly disparate pieces of information, recognizing patterns and opportunities that others may miss. This ability to think "outside the box" and to challenge short-term conventional thought is what sets visionary investors apart.

"Investor vision" is not an esoteric idea; it involves a thought process for developing a strategic roadmap that guides investment decisions. A visionary investor recognizes that the true value of a company lies not only in its current financial metrics, but in its potential to achieve sustainable growth and profitability over the long term.

Creating a vision represents the art of investing. Picture a skilled artist facing a blank canvas with a brush in one hand and a palette of colors in the other. The artist envisions a masterpiece before a single stroke graces the surface. Similarly, an insightful investor approaches business opportunities with a visionary perspective. The canvas, in this case, is an industry landscape primed for a successful business to take form.

In the realm of investing, vision is the ability to envision what a company could become, beyond what it is at present. Warren Buffett attributes a significant part of his success to this principle. His visionary approach to investing is not fixated on quarterly reports or short-term gains, but on the enduring long-term potential of a business. Gazing far beyond the mere numbers that populate the financial model in a spreadsheet that so many investors rely on, Buffett's vision peers into the heart of a company, seeking to uncover its unique strengths, competitive advantages, and capacity to take advantage of market dynamics. This ability to discern the essence of a business and to grasp its true potential is the hallmark of visionary investment. Warren Buffett integrates the powerful blend of analytical prowess, strategic thinking, vision, and unwavering conviction of a successful visionary investor.

The path of a visionary investor is not without challenges: Some may struggle to comprehend this unconventional approach and feel skepticism and doubt about visionary investment decisions. Moreover, realizing a business vision may require extreme patience and persistence, as it may take years for an investment to mature and bear fruit. In addition, a business vision could be wrong and may need to be adapted to an industry landscape as it unfolds.

Despite these potential pitfalls, visionary investors must remain steadfast in their convictions, driven by an unwavering belief in their ability to identify and understand companies that have exceptional potential. This type of investor is not swayed by monetary fluctuations in stock price, but anchored in the belief of a company's intrinsic value and its capacity to evolve, innovate, and grow in the future. Such investors recognize

that the true rewards of investing lie not in short-term gains but in the creation of enduring value for the company, its stakeholders, and society as a whole.

The Reality-Based Investor

In contrast to visionary investors, reality investors are focused on the "here and now" of a company. Such an investor is not interested in hearing about any vision of the future, which is simply hypothetical; rather, his aim is to focus deeply on the numbers representing a business now and in the past, which can reliably be forecasted to continue into the foreseeable future. The reality investor seeks absolute certainty when considering investing in a business, and he desires to minimize his downside risk while grabbing upside potential. Such investors are interested in ascertaining a stock's value (and price) one year to five years out. They come from Missouri, the Show-Me State: Show me the relevant current and past numbers, and show me their consistency—focus on returns on capital, sales growth, unit economics, profit margin trends, cash flow generation, and capital allocation (acquisitions, stock-buybacks, etc.).

These "pure value" investors seek to purchase a company based on metrics that show it to be currently undervalued but ultimately destined to find its true value within a determined time frame. The vision of the future business is not reality; in contrast, numbers talk while the business walks, providing these investors confidence that returns are highly probable on their investment.

The problem with this approach? We mentioned in last year's letter some businesses of the past that once had terrific investing metrics for the show-me-now reality investor—Kodak, Xerox, Sears, J.C. Penney, Blockbuster, Radio Shack, to name a few. As Charlie Munger once said, "All I want to know is where I'm going to die so I'll never go there." Each of these companies ended up either in the investment graveyard or barely moving along against tremendous headwinds of competition that had overtaken their formerly leading positions. In fact, visionary investors that had peered into the future of these businesses that were magnets for deep value investors and focused on the reality of their past numbers clearly saw that they were faltering and stayed away from allocating any money into these stocks.

One may conclude that weighing heavily on known numbers and fundamentals that could change should not play any part of an investment evaluation. A large portion of any company's valuation is based on an assessment of its financial metrics, however, including understanding accounting—the basic language of business that reveals the strength or weakness of an enterprise over time. Reality-based assessment of a potential investment represents the science of investing and is very important.

Balancing Vision-Based vs Reality-Based Investing

Back to our original question: Within this vision-reality spectrum, where should an investor's focus fall?

It is probably obvious by now that we would advise investors to apply a blend of both vision and reality when evaluating an investment in any business. Blending both art and science in any endeavor is easier said than done, however, and there is always a question of how much emphasis should be placed on each—naturally, the answer is "it all depends." When assessing businesses in industries that will not change very much over time—think candy—it makes sense for investors to place a greater emphasis on the reality of past and present numbers to predict future results. On the other hand, evaluating a business in a sector such as technology that operates in an ever-changing industry landscape requires a heavier emphasis on envisioning its future.

It may seem plausible to think that investment success can be achieved by focusing only on businesses that "fit" an investor's natural perspective about investing—whether vision-based or reality-based. This proves difficult in practice—in the case of the pure reality investor, for example, many dynamic, growing companies that make up a large portion of the market require investor vision—think Apple, Microsoft, Amazon, Alphabet, Meta, etc. Missing out on placing a considerable portion of portfolio funds in these companies can mean significantly lagging average market returns. In addition, these companies are powerful, have a future, and have cemented themselves into the market infrastructure. Today's investors are essentially forced into a position of having to blend both the art of vision and the science of reality when investing.

So: How should an investor go about developing a vision for a business? The key is to develop a sense of "clarity" around the business. At the outset, obtaining clarity requires a settled state of mind that allows one's mind to absorb, through extensive study, the business and its industry context. The trick is to intently focus on the most crucial points while slowing down one's thought process, allowing the mind to become unchained from emotion while studying. A baseball analogy may help to explain this concept: The famous hitter, Ted Williams, once described how he could see the seams on a baseball as it was travelling toward the plate—keeping this intense focus gave him the perception that the ball was going slower than it actually was. This provided Ted Williams "more time" to decide whether or not to swing at a pitch that was heading into his "hitting zone." In similar fashion, an investor should focus intently on the important competitive attributes of a business, developing a clear vision, or story, for how a business might be positioned to strengthen its competitive position in the future. When an opportunity arises, and the business metrics come into the "investment zone," the individual is prepared to swing at the pitch. This represents the artistic side of investing.

How should an investor determine the reality of a business? More important than developing a full understanding of the underlying financial metrics of a business, the key is to develop a sense of "movement" around the financial metrics. For example, identifying a consistent deterioration in profit margins along with increased capital intensity could signal lower returns on capital for the business over time. Conversely, noticing a consistent increase in profit margins along with decreased capital intensity could indicate higher returns on capital for the business over time. Noticing certain types of financial shifts—or movements—in financial metrics can be either value-destroying or value-enhancing for a business.

Ultimately, an investor like Warren Buffett exercises extraordinary talent that is difficult to replicate. Developing an investment approach that applies both artful vision and knowledge-based facts is like an artist attempting to mimic Leonardo DaVinci's talent. A visionary artist attempting to emulate Leonardo DaVinci would find it difficult, because his paintings incorporate knowledge about anatomy, physiology, light, reflection, and refraction—all areas of science that Leonardo had mastered through decades of study. In short, attempting to duplicate Mr. Buffett's talent would be nearly impossible, requiring mastery of both his art of vision and of financial science that took him decades to develop—essentially replicating extraordinary investment genius.

Although it may be impossible to achieve Warren Buffet-level investment genius, working at cultivating the art and science of investing is well worth pursuing—in fact, it remains an aptitude that few on Wall Street have any interest in acquiring, because it is a difficult, lifelong endeavor that does not produce immediate results. In the long run, mastering a multidimensional approach that encompasses both the art and science of investing is important for investment success, and although the investment results may not be equal to Mr. Buffett's, they will likely be satisfactory.

The Banker, the Dealmaker, and the Operator-Investor Business Maker
(Or: How to approximate multidimensional investment genius)

> Rub-a-dub-dub,
> Three investors in a tub,
> And who do you think they be?
> The Banker, the Dealmaker, the Operator-Investor Business Maker,
> And all of them out to maximize returns from their investments.

Since investment genius is not something that many possess, ordinary investors evaluating a company can simulate a multidimensional perspective that blends the artist's vision with the scientist's pursuit of facts by placing themselves in the shoes of the Banker, the Dealmaker, and the Operator-Investor Business Maker. Such an exercise helps to "break" one's natural thought process and frames of reference, enabling a deeper and more objective analysis of the opportunity.

The Banker (and Insurance) Perspective

A "Banker's perspective" requires the investor to first assess a company's risks, including calculating changes to returns on capital, sales growth, unit economics, profit margins, cash flow generation, and capital allocation (especially in the area of acquisitions). The Banker also evaluates the capital structure of the business. For example, when a Banker evaluates a company's loan application, it carefully scrutinizes a number of financial metrics that include understanding how much outstanding debt the business carries, the bank's loan position within the hierarchy of loans from other creditors (i.e., first in line, last in line, etc.), how easily loan payments would likely be covered via the business' profits under stressful conditions, and ascertaining—with a high degree of certainty—the business' ability to produce necessary cash flows to service the loan.

Taking the Banker's perspective helps investors develop a true sense of a business' important financial metrics and, consequently, whether or not a return on their investment is plausible. For example: Let's say an investor is considering making an investment in the common stock of a company that has $10 million of debt at 6% interest, which requires the business to produce $600,000 per year to service this debt on an interest-only loan. If the business is not placing any funds toward future growth and is only able to produce $600,000 of distributable cash per year before paying any obligations to other stakeholders, it is obvious that zero money would be left for shareholders who are last in line for receiving any proceeds from the company (creditors are first in line for any payments from the company). In this type of situation, investors may purchase common stock of the company at a very low price, with the hope that the business will improve its profitability and produce excess cash for distribution to shareholders in the future. (We would place this opportunity in the "speculative" category).

Similar to a "Banker's perspective," applying an "insurance perspective" when analyzing risks in a potential investment can be illuminating. For example, an insurance underwriter initially looks at a policy's risk of loss. The first consideration is not, "how much money are we going to make?" Rather, an insurance mindset involves understanding that risk and random events are normal aspects of everyday life and that an aggregate analysis of various potential scenarios—including remote loss—is essential to properly price policies and obtain a long-term profit. In other words, investors should view investing in a business through a probabilistic vs. absolute lens and accept risks that they can reasonably appraise. It is also essential to monitor and manage aggregation risk in an investment portfolio diligently. For example, if an insurer accepts an over-weighted number of policies written from different agents for automobile, home, and commercial property along the eastern coast of Florida, a hurricane could create a domino impact on company profitability. Similarly, if an investor puts all her eggs in a basket of similar stocks (e.g., financial enterprises), a market shock—such as a lasting jump in interest rates—could impact the entire portfolio's value—even if returns had been stellar over previous years.

Ultimately, placing oneself in the shoes of the Banker and Insurer forces the investor to focus on assessing the realities of a business and to closely monitor important financial metrics and risk trends relevant to investing in that business.

The Dealmaker

A "Dealmaker's perspective" focuses on any potential restructuring in a business that would serve as a catalyst for creating appreciable value on an investment. For example, a dealmaker mindset may take into account arbitrage, whereby an investor profits from differences in price for a company undergoing an acquisition. Let's say that ABC Co. announces an all-cash purchase of XYZ Co. on January 2nd, 2024 for $20 per share, with an expected acquisition closing date of around July 1st, 2024. On the date of the acquisition announcement, the stock of XYZ Co. jumps from $15.25 to $18.20 per share. XYZ's stock price did not increase to the full $20 offer because:

1) The value of money changes over time—i.e., $20 six months from now is worth less today due to inflation.
2) The deal may become delayed, and the closing date may be pushed further out than July 1st.

3) There is some possibility that the deal may fall through, and ABC will not end up completing the acquisition of XYZ.

With this knowledge, we can assess the probable return we would obtain if we purchase XYZ stock on January 2nd at $18.20 per share and receive an anticipated $20 of cash on July 1st. In this hypothetical case, we can calculate a probability of receiving an approximate 20% annualized return on our purchase, plus any dividends distributed by XYZ between the time of the announcement and the final acquisition date.

The Dealmaker looks for significant opportunities inherent in any change in a business' structure that will lead to a greater valuation on his investment—this can include acquisitions, divestitures of businesses, debt restructuring, or business restructuring that may increase profit margins and returns on capital.

Placing oneself in the shoes of the Dealmaker forces investors to evaluate the following as they pursue opportunities:

- **Industry Dynamics: Investing in the best business within an industry that seems out of favor.** Some industries that may experience growth over the long term fall out of favor from time to time, creating an opportunity for the dealmaker to purchase the best company within that industry at a significant discount to the company's long-term value.

- **Hidden Assets: Uncovering hidden assets or undervalued potential within a company.** A Dealmaker will thoroughly analyze financial statements, assets, and market position for each business segment in a company to identify opportunities that may be overlooked by others—such "hidden assets" could be unlocked through strategic initiatives or restructuring. For example, around 2004, we made an investment in Nestle, the multinational packaged food company based in Switzerland. Although we were very interested in Nestle's industry position in its core business areas such as chocolate, coffee, and pet food, we were more interested in other assets that we believed were not fully reflected in the company's valuation. At the time of our investment, Nestle owned 75% of Alcon, the pharmaceutical, medical device, and eye care company that Nestle spun off into a public company in 2002, selling a 25% stake through a public offering. In addition, Nestle owned (and still owns) 20% of Paris-based L'Oreal, the world's largest beauty products company, which is controlled by the Bettencourt family.

  When we added the value of Nestle's ownership share of Alcon and L'Oreal to the value of Nestle's core businesses, it was clear that their combined value exceeded the public market capitalization for Nestle at the time. Applying the Dealmaker's perspective, we purchased Nestle's stock at a discount and, over a period of several years, the intrinsic value of these holdings came to be realized in Nestle's stock price.

- **Value Creation: Seeking catalysts for innovation or efficiency.** Dealmakers understand the broad operations for a business and seek gains that can be achieved when a company combines complementary strengths and/or increases collaboration and knowledge-sharing. They identify true potential synergies in a business that would leverage an investment to achieve greater value. In 2018, we started making an investment in FedEx Corporation At the time, we noted that FedEx operated three separate businesses—FedEx, FedEx Ground, and FedEx Freight—under an umbrella corporate structure. Although each of these siloed business segments was a powerful entity in its own right, running them as separate businesses within the corporate structure duplicated resources and efforts, resulting in large inefficiencies reflected in a profit margin that was 30% lower than its largest competitor, UPS, which has similar business segments to FedEx but runs its company as one entity. From a Dealmaker's perspective, we anticipated that FedEx would eventually combine its three business segments and operate more efficiently as one company—greatly improving its profit margins, capital intensity, free cash flow, and value for shareholders. Although it took more than four years, in 2023 FedEx finally embarked on DRIVE, a comprehensive program to consolidate its three business segments into one organization to improve efficiency and the company's long-term profitability.

Dealmakers also spot value-creation opportunities when companies announce business spin-offs (whereby a company distributes shares of a subsidiary to existing shareholders, and the subsidiary becomes a completely independent company), split-outs (similar to a spin-off, except that existing shareholders have an option to choose between receiving shares in the new company or keeping their shares in the parent company), carve-outs (in which the parent company sells a portion of its ownership in a subsidiary to the public through an initial public offering and receives cash from the sale of shares), aggressive stock-buybacks, debt reduction, and other strategies.

A final point: A Dealmaker aggressively looks for what can kill a business and destroy his investment. Value destroyers such as disruption (whereby a product or technology becomes popular enough to replace a traditional or common product or service) and disintermediation (the removal of one or more middlemen from a transaction, supply chain, or decision-making process) can permanently change the manufacturing, distribution, or sale of a product, altering a company's business model and leading to destruction of intrinsic value.

The Operator-Investor Business Maker

Taking an "Operator-Investor Business Maker perspective" involves assuming the CEO's role—placing oneself in the shoes of the person leading and managing the company. This exercise forces the investor to look at several areas that are key to running a company, including its position within its industry, market trends, channel management, employee and customer satisfaction, etc. The CEO for any company has a unique view of the business and continuously evaluates the following:

- **Business Strategy**: CEOs create a vision for their business by strategizing from a long-term, holistic perspective, taking into account the company's overall direction, goals, and competitive landscape. They consider factors such as market trends and opportunities as well as the business' competitive position. The CEO closely monitors industry trends, emerging technologies, and shifting customer preferences to identify new growth opportunities and potential threats. The CEO also assesses the company's position within the industry, evaluating its strengths, weaknesses, and competitive advantages. This involves understanding the company's current market share, brand reputation, product differentiation, and cost structure.
- **Business Value Creation:** Financial performance and sustainability are paramount, and CEOs analyze the company's financial performance, including profitability, cash flow, and asset utilization. They consider long-term capital allocation that will generate sustainable growth and intrinsic value for the company. The CEO also has a deep sense of the company's current value and the knowledge and understanding to create added economic value for the business over time, increasing the long-term per-share intrinsic value for shareholders.
- **Executive Management and Leadership*:*** CEOs assess the company's organizational capabilities and resources, including its workforce, technology infrastructure, and management capabilities. They identify areas for improvement and ensure that the organization has the necessary resources to execute the company's strategy. The CEO also oversees overall cultural development as well as the development of the next generation of leaders to manage the company.
- **Corporate Governance: Stakeholder Interests*:*** CEOs consider the interests of various stakeholders, including shareholders, employees, customers, suppliers, and the community. They manage the needs of these stakeholders to ensure long-term success and sustainable growth for the company.

In summary, by taking different perspectives, an individual evaluating an investment can naturally blend the artistic and scientific approaches without having to apply an "art and science checklist" that would end up producing an investment painting that looks as if it were created from a paint-by-numbers kit. Rather, it is important to free one's mind from the conventional way of evaluating a business in the manner that is taught on Wall Street and in business schools and, instead, to develop an investment painting by viewing the investment from different dimensions and blending various visionary and fact-based disciplines .

* * *

Founders' investment behavior will remain simple: We adhere tightly to both artistic and scientific philosophies regarding value investing. We seek to invest in companies for which we can develop a clear vision of the future while understanding their business realities today. Although we are unable to provide an exact answer to questions about any market's near-term direction, we remain agnostic to the market's short-term movements, avoiding the influence of emotional reactions to fluctuations. Instead, we will keep our eyes open for opportunities that emerge in an uncertain environment—and thus, we will continue to exercise patient vigilance. Given the increasingly uncertain market behavior of recent times, we are keeping one of our favorite quotes top of mind:

> **"The less prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own affairs."**
>
> ***–Warren Buffett***

We will continue to invest with our eyes wide open and with the confidence that we have acquired a collection of securities at prices that will provide a fair return over time (despite gyrating markets and higher-than-normal speculation). This includes our investments in selected fixed-income instruments that offer a commensurate risk/reward relationship, as well as acquiring interests in strong individual companies through the equity market that are very profitable and have a wide competitive moat. Our investment activity in all market conditions confirms our conviction about another Warren Buffett quote:

> **"We will continue to price, rather than time, our purchases. In our view, it is folly to forgo buying shares in an outstanding business whose long-term future is predictable, because of short-term worries about an economy or a stock market that we know to be unpredictable. Why scrap an informed decision because of an uninformed guess?"**
>
> ***–Warren Buffett***

Equity Holdings: 2023 Highlights

The intrinsic value of our aggregate equity holdings gained traction during 2023, despite the economic pressure of high interest rates that increase both consumer and business costs and decrease spending. We remain positive about our capital allocations, including expected returns over the next 10 years, despite the considerable price changes that surfaced over the past 24 months that will likely continue into the future.

Given uncertain market circumstances, we'd like to reiterate the following points about our core holdings:

- **We are confident in the high character displayed by the leadership of the companies in our aggregate portfolio** and believe that the companies are managed in a resilient manner that allows them to adapt in changing times.
- **We believe that we are business partners in actual companies that are focused on building sustainable and secure businesses that increase long-term profitability,** as opposed to being members of a group of shareholders that are interested only in a rising stock price that is divorced from a commensurate movement in business value.
- **We believe that we own a collection of businesses that fall into the "valuable" and "invaluable" categories and that their increasing intrinsic business value will be realized over time.**
- **Our invested companies have business models that are durable, resilient, and able to adapt to a changing marketplace.** Our companies possess a long-term competitive advantage in their respective industries and have earnings capabilities that are sustainable over the foreseeable future.

As long-term investors, we are confident that the wonderful franchises in which we have an ownership stake will continue to strengthen their long-term enterprises, independent of any short-term gyrations in their stock prices.

The following is a summary of business highlights from our portfolio companies during 2023, along with our expectations for 2024.

CONSUMER GROUP

Consumer-related businesses continue to face challenging economic and competitive conditions due to inflation that can dampen demand for their products. Nevertheless, we are pleased with the resilient performance of our Consumer Group in 2023. We expect to see positive business results continue during 2024 and remain optimistic about the long-term prospects of our global consumer franchises—specifically, PepsiCo (as well as Coca-Cola, in which we hold a smaller position).

PepsiCo

Our primary consumer holding—PepsiCo—had another very good year, despite continuing headwinds that caused its cost of goods to rise with inflation again during 2023. Over the past 12 months, reported net sales and operating profits for PepsiCo increased approximately 7% and 11%, respectively, as consumers continued to favor PepsiCo's beverage and snack food products, even with the continual inflation-related price increases. The future of PepsiCo remains bright as this core consumer goods company continues to cultivate its presence in both developed and emerging global markets.

1. According to Statista, an estimated $840 billion of non-alcohol soft drink beverages were served around the globe in 2023, and the market is expected to grow between 4% and 6% in 2024. The global non-alcohol concentrated syrup market, which PepsiCo and Coca-Cola dominate, is expected to reach $58 billion by 2030, according to a report by DataM Intelligence. This represents an annual growth rate of 6.5% based on increasing product demand across the globe. In addition, the world's population

continues to grow and is expected to increase from 8 billion today to 10 billion by 2055. Over the long term, an increase in the population creates more demand for food and beverages. We can conclude that, while PepsiCo's and Coke's beverage products sold worldwide represent a large portion of the beverage market, there's a lot more market share to grab. We believe that PepsiCo and Coke are positioned to become much larger in the future as emerging markets such as China and India continue to develop their middle class.

2. PepsiCo owns more than 20 brands that generate more than $1 billion a year in sales and has operations around the world. In 2023, PepsiCo's products were distributed across more than 200 countries and generated annual net revenues of more than $92 billion. PepsiCo's beverage products encompass well-known brands such as flagship Pepsi, Gatorade, Aquafina, and ready-to-drink tea and coffee drinks. If the world desires a new type of drink (such as health-focused beverages), it is likely that PepsiCo will produce and distribute it—in many varieties. PepsiCo is also the largest snack-food company in the world, with a global product offering that exceeds its beverage counterpart.

PepsiCo is a resilient, adaptable, and sustainable business and should be considered "extremely valuable" —an enterprise that one can envision to grow far into the future and stand the test of time. The secret to PepsiCo's resilience and adaptability is its flexible and impenetrable distribution system the company has built over the past century. PepsiCo's industry stronghold is its large, complex distribution system that is difficult for any competitor to duplicate. Smaller competitors wishing to enter multiple markets and develop scale with a new beverage or snack product have little choice but to make an agreement with PepsiCo for the distribution and delivery of their products using PepsiCo's system.

PepsiCo's consistent brand development, product diversity, and growing global penetration provide investors the ability to forecast the future with a relatively high degree of probability. It is very likely that each of PepsiCo's business segments—beverages and snack foods—will substantially penetrate developing markets over the next 25 years, and the accumulated potential growth of these businesses cannot be fully identified using traditional valuation models—in other words, PepsiCo's business holds superior intrinsic value, underscored by the company's long-term value-creation potential.

PepsiCo continued to increase its returns to shareholders, raising the annual dividend by 10% in 2023, from $4.60 per share to $5.06 per share. We expect PepsiCo to raise its dividend in 2024 to approximately $5.30 per share, which implies an approximate forward dividend yield of 3.12% at the year-end stock price. We also anticipate that the company will repurchase $1.5 billion of stock during the next 12 months. This action would add another .65% return to shareholders, representing an approximate 3.8% forward pass-through yield.

In summary, PepsiCo continues to prove resilient to business downturns and demonstrates an ability to adapt to market system deterrents. We like the long-term potential and economics of the beverage and snacks business and think this industry holds a multi-decade growth opportunity for dominant companies. PepsiCo has a large and growing position in these business segments and will remain a long-term holding in our portfolio.

TRANSPORTATION GROUP

Our primary transportation holdings—CSX Railroad and FedEx Corporation—are unique businesses that continue to grow as economies develop around the globe. These businesses are capital-intensive and sensitive to economic cycles, however, which subjects them to setbacks when tougher economic conditions emerge from time to time, such as in 2022 and 2023. We remain sanguine about future global economic growth, however, and we believe that these businesses will gain further traction in upcoming years. Future growth in the European and Asian economies, augmented by further U.S. infrastructure investment, should allow these businesses to make advances over the next decade.

Our transportation group is composed mostly of highly networked, infrastructure-related businesses focused on transportation efficiency and product innovation. Each of these infrastructure businesses offers high-end products and/or services that are extremely expensive to produce—attributes that normally would be

detrimental to a business' profitability. These special businesses possess "networking effects" that allow profitability to grow faster than revenue over time, however, due to expanded customer usage occurring over fixed-cost investments. As globalization continues, the consolidation of businesses involved in transporting purchased goods will be a natural development, with fewer companies positioned to provide the breadth of products and services customers demand. Thus, the long-term trend is for these transportation companies to become ever more entrenched, expanding their competitive advantages—and profitability.

Our largest transportation investments—CSX and FedEx—have comparable advantages that allow them to be resilient and adapt to industry change. For example, it has taken nearly two centuries to build the U.S. railroad infrastructure, and it would take an extraordinary amount of time and capital to create a business transportation system that competes with railroads such as CSX, Union Pacific (a smaller Founders position), and Burlington Northern (which is owned by Berkshire Hathaway—another Founders holding). This holds true for the freight and overnight package sectors as well—FedEx and UPS have spent decades building out their air and ground infrastructures, and it would take enormous time and capital to create a transportation system to compete with these dominating entities. In essence, resilience and adaptability are built into these businesses owing to their deep, impenetrable networks that are nearly irreplaceable. The "network effect" also creates an oligopoly, with just a few companies controlling most of the industry.

Although transportation businesses are capital-intensive, certain other attributes make this type of investment attractive in any economic environment. For example, in today's rapidly changing distribution and logistics environment, companies seek to run more efficiently to minimize costs. Moving greater amounts of goods over fixed-rail, -air, and -ground infrastructures instead of via higher-cost alternatives, such as traditional trucking, enables companies to lower costs and achieve large productivity gains. This cost difference becomes even more desirable by companies during a higher inflation period, such as the one we have been experiencing.

CSX Railroad

CSX is one of the nation's oldest railroads, with roots in the nation's first comm21on carrier—the Baltimore & Ohio (B&O) Railroad, chartered in 1827. As one of two major north/south railroads, CSX provides an important link to the transportation supply chain through its approximately 20,000 route miles of track that serves major population centers in 26 states east of the Mississippi River, the District of Columbia, and the Canadian provinces of Ontario and Quebec. The company is large, with more than 3,600 locomotives and more than 66,000 freight and container cars that provide access to more than 70 ocean, river, and lake port terminals along the Atlantic and Gulf coasts, the Mississippi River, the Great Lakes, and the St. Lawrence Seaway. CSX also has an intermodal business that links customers to railroads via trucks and terminals.

During 2023, CSX generated approximately $14.6 billion in revenue—approximately 1.6% less than in 2022—while net profits decreased around 5.5%, to nearly $3.7 billion. As we stated last year, a portion of the previous year's revenue and profit increase was a result of CSX's ability to pass fuel increases on to customers through fuel surcharges—a "profit bump" that was not likely to occur in ensuing years. Indeed, the profit bump was lost in 2023.

The company continues to execute on its "precision-scheduled railroading" operating model, which focuses on developing and strictly maintaining a scheduled service plan in a way that optimizes railway assets. CSX has been applying this innovative new operating model successfully over recent years, improving its customer service, lowering costs, and increasing free cash flow. We believe that most of the efficiencies to be gained from precision-scheduled railroading have now been realized, though we do expect moderate efficiencies to emerge at CSX in the future as revenue continues to climb while expenses remain under control.

During 2023, CSX distributed approximately $4.75 billion of cash to shareholders in the form of dividends (around $880 million) and share repurchases (another $3.87 billion). As expected, CSX earnings per share remained flat at $1.83 per share. In 2024, we anticipate that CSX per-share earnings will increase around 9%, to $2.00 per share, given the anticipated economic recovery that is likely to occur over the upcoming year. We expect CSX to distribute an additional $5 billion to shareholders through a combined dividend and stock

repurchase program. This provides shareholders with an approximate 7.3% forward pass-through yield at CSX's year-end price, and we believe that this yield will continue to grow over time as freight traffic increases over CSX's fixed-rail network.

In summary, we think our investment in CSX is an opportunity to participate in the long-term growth of the U.S. and global economies, which will likely accelerate over the next 10 years because of anticipated U.S. infrastructure investment. We believe that the growth in CSX's freight volume will endure over the upcoming decade and may increase more than many investment analysts expect. Furthermore, we expect CSX to continue to execute on precision-scheduled railroading to maintain the company's expenses while increasing revenues, further improving its operating ratio. (The operating ratio is an important measurement in the railroad industry, representing the percentage of revenue used to operate the railroad—the lower, the better.) The projected long-term growth in freight volume and strong pricing, coupled with lower expenses, will continue to leverage CSX's income and cash from operating activities, which will support the availability of large amounts of cash for distribution to shareholders. We will remain long-term owners of CSX, which occupies an important position in our portfolio.

FedEx Corporation

FedEx provides a broad portfolio of transportation, e-commerce, and business services through its collective business segments that operate under the respected FedEx brand. The organization is large and consists of a complex network through three primary business segments:

- **FedEx Express** is the world's largest express transportation company, offering time-definite delivery to more than 220 countries and territories through 650 airports, connecting markets that represent more than 99% of the world's gross domestic product. FedEx Express represents around 48% of total FedEx revenues and 37% of its normalized operating profit. FedEx Express is the original business segment started by Fred Smith (FedEx's Founder and Executive Chairman) and is the world's largest provider of guaranteed express delivery services. FedEx Express provides same-day, overnight, and multi-day delivery services for documents, packages, and freight through a network of 82,000 ground vehicles, 700 aircraft, and approximately 70,000 drop-off locations. The bulk of FedEx Express' revenue (60%) is for time-sensitive domestic U.S. shipments of packages and freight. The remaining 40% comprises international cross-border shipments and domestic shipments within foreign countries.
- **FedEx Ground** is a leading North American provider of small-package ground delivery services. FedEx Ground represents 40% of total FedEx Corporation revenues and 40% of the company's normalized operating profit. FedEx Ground is North America's second-largest ground transportation and package delivery company (UPS—United Parcel Service—is the largest). FedEx Ground makes residential deliveries seven days per week that are largely related to e-commerce packages involving most of the U.S. population. FedEx Ground is a complex business that operates a hub-and-spoke sorting and distribution system that consists of more than 700 facilities, including 40 hubs, in the U.S. and Canada. The FedEx Ground operation relies on third-party providers for line-haul transportation between its facilities and hubs and uses a fleet of approximately 100,000 vehicles that are owned or leased by third-party service providers for pick-ups and deliveries.
- **FedEx Freight** is a leading North American provider of less-than-truckload ("LTL") freight services across all lengths of haul. FedEx Freight offers FedEx Freight Priority when speed is critical to meet a customer's supply chain needs, and FedEx Freight Economy when a customer can trade time for cost savings. FedEx Freight represents 12% of total revenues and approximately 23% of the company's operating profits. Unlike the outsourced transportation model in the Ground segment, FedEx Freight primarily uses FedEx-owned trucks and FedEx employees to complete customer shipments. In contrast to the delivery of packages or documents that constitute the primary business of FedEx Express and FedEx Ground, FedEx Freight mostly transports bulkier items and pallets of goods.

Through a complex global transportation, information technology, and retail network, we believe FedEx is uniquely positioned to connect customers and consumers throughout the world. The following large trends provide FedEx an opportunity for long-term expansion and unprecedented integration of customer goods, services, and information:

- **Growth of e-commerce:** E-commerce continues to be a catalyst for FedEx and a vital growth engine for all business segments as the internet is increasingly used to purchase goods and services. While FedEx residential e-commerce revenues are much smaller than business-to-business revenues, residential e-commerce is the fastest-growing delivery service sector and requires innovation to make delivery to consumers ever more flexible, convenient, efficient, and cost-effective. As global transportation and technology networks continue to develop, FedEx will greatly benefit from the growth of e-commerce.
- **Globalization of trade:** As the world's economy becomes more fully integrated, companies are increasingly sourcing and selling globally. With customers in more than 220 countries and territories, FedEx serves as a crucial part of the supply chain through its global reach, delivery services, and information capabilities. Despite trade tensions, globalization will drive international volume growth over the long term.
- **Supply chains and logistics:** Companies of all sizes continue to depend on the delivery of just-in-time inventory to help them compete. FedEx integrates its business segments with customer supply chains and provides real-time information to manage inventory-in-motion, which reduces overhead and obsolescence and speeds time to market. FedEx is rolling out same-day and autonomous special delivery systems that are positioned to lead the industry in logistics efficiency.

It would be extremely difficult, costly, and time-consuming to replicate the FedEx global network, which includes the world's largest all-cargo air fleet and connects nearly 100% of the global economy.

Over approximately five years since our initial purchase, ending with FedEx's fiscal year-end of May 2023, the company's revenues increased at a compounded annual growth rate of 6.6%, reaching $90.1 billion in its fiscal year 2023. Over the same five-year period, adjusted earnings per share grew at a compounded annual growth rate of approximately 5.5%. During its fiscal year ending May 2024, FedEx's revenues are expected to decline slightly to around $88.5 billion, while per-share profits are expected to increase 18%, to $17.65, due to the previously mentioned DRIVE cost-saving program FedEx initiated at the beginning of 2023. The DRIVE consolidation plan brought FedEx Express, FedEx Ground, FedEx Services, and other FedEx operating companies into a unified FedEx Corporation, resulting in a fully integrated and more efficient air-ground network operating under the respected FedEx brand.

FedEx is a capital-intensive, economically sensitive business, and despite its strong competitive advantages, its business segments are highly cyclical. Over the long term, we expect FedEx's revenues to continue to grow and its margins to increase as the organization gains operating efficiencies from the DRIVE consolidation program. We remain positive about our long-term investment in FedEx and believe that the shipment and delivery of goods throughout the world will continue to grow. Greater customer use of this company's fixed network will improve profitability and returns on capital in the future, adding value to FedEx and shareholders.

FedEx Corp. is expected to earn $4.45 billion of net income in its fiscal year ending May 2024, or an adjusted $17.65 per share. We expect combined per-share earnings to increase more than 20% in the fiscal year ending May 2025, to $21.50 per share. When comparing forward earnings to the company's year-end stock price of $253 per share, investors are receiving an entry earnings yield of 8.5% on their FedEx investment—and we expect per-share earnings to grow over the next five years, especially given the company's strategy to take advantage of the growing interconnected global economy and to improve its profit margins by lowering its cost structure and reducing future capital intensity.

TECHNOLOGY & COMMUNICATION GROUP

Each year, we begin this section by highlighting the investment opportunity potential of the information technology and communication sector, along with the difficulty of choosing the right companies to invest in over the long term. Business disruption is the norm in this sector and, therefore, companies and their investors can never rest on past success. During 2023, the technology and communication sector continued to contend with breakneck change as device power continued to grow, cloud computing gained additional traction, social media interaction and individualized e-tailing continued to flourish, and artificial intelligence (AI) started to become fully integrated into every aspect of its interface with technology.

The inherent disruption and warp-speed change within the technology and communication sector continue to make it extremely difficult to determine which companies will succeed or fail. Arguably, this sector requires an investor to apply visionary evaluation more than any other industry.

Just 17 years ago, Steve Jobs introduced the iPhone to the world, and this single device allowed Apple to become a primary global technology disrupter. The opportunity to attain the kind of exponential gains achieved in the early days of smartphone technology are gone, since market share-hungry competitors started developing “copycat” Apple products. Nevertheless, Apple continues to be a leading technological innovator, introducing additional innovative devices and services to the consumer.

Amazon remains the leading technology disrupter with its cloud service business, Amazon Web Services (AWS), which is used by companies such as Netflix to manage and stream content to customers. Microsoft, however, has quickly become a leading cloud service provider to businesses and has secured a large share of the market as corporations integrate their computing requirements.

Computer miniaturization, the “Cloud Computing Era,” and the rapid emergence of AI software are driving a new generation of products and services that empower individuals to interconnect, shop, be entertained, and stay informed 24 hours a day, 7 days a week. Which companies gain competitive control in the evolving technology and communication ecosystem continues to be anyone’s guess. We remain committed to watching for and responding to investment opportunities as they arise in this fast-moving arena. Our goal is to identify the difference between price and value with certain technology and communication companies that we believe occupy a strong competitive position. We continue to seek resilient and adaptable businesses in an evolving industry characterized by ongoing disruption. Even with this objective, it is difficult to point to a single specific company in this industry that could be placed in the “guaranteed invaluable business basket”—too much ongoing disruption makes it impossible to call.

Therefore, we are invested in what we believe to be technology and communication companies that provide core products that all individual and commercial customers need. Our large technology and communication holdings include Microsoft, Alphabet (Google), and Meta Platforms (Facebook & Instagram).

Microsoft

We often note that, since Microsoft’s debut as a public company in 1986, the company has had to be resilient through several disruptions that have required the organization to adapt its business. Over the past 37 years, Microsoft has faced challenging times with a barrage of competition, the U.S. government’s monopoly lawsuit, and an evolving technology landscape.

Ten years ago, Microsoft was literally written off by investors as a dinosaur as the company struggled with its primary product—Windows—in a dramatically changing technology landscape in which consumers were quickly moving toward companies that offered full hardware and software integration across all their devices (like Apple products).

In early 2014, Microsoft’s board chose Satya Nadella to lead the company. Applying his background in cloud and enterprise computing, within 72 months, Mr. Nadella led Microsoft back to the forefront of technology change. The organization turned on a dime, successfully shifting its primary focus away from Windows and

devices and emerging as a leader in providing enterprise applications and cloud-based services to small, medium-size, and large businesses.

According to Grand View Research, the cloud computing market will reach $1.6 trillion by 2030, representing a compounded annual growth rate of more than 15%. Microsoft, currently with a 23% share of the cloud computing market (up from 21% last year), is highly focused on growing its cloud computing platform, Azure. To this end, during 2023, Microsoft committed to a $13 billion total investment in the artificial intelligence research lab, OpenAI, representing up to a 49% economic interest in the for-profit portion of the maker of ChatGPT, a chatbot credited with starting the AI boom that is widely seen as the fastest-growing consumer internet application in history. We expect Microsoft to integrate AI throughout all its cloud computing products and to leverage this AI investment to achieve significant gains in cloud computing over the next decade.

The emergence of cloud computing—the delivery of computing as a service instead of as a product—has vastly changed the technology landscape since its introduction in 2006. Using cloud computing, customers share resources, software, and information that are provided as a metered service over the Internet to personal computers and other devices. Cloud computing is analogous to an electric utility, whereby the power station delivers power to the electrical grid, and consumers draw down on that power as they need it—and are charged for their usage (in the case of cloud computing, through subscription-based payment). The infrastructure that supports cloud computing comprises large data centers (i.e., server farms) that are owned and operated by companies such as Amazon (32% market share), Microsoft (23% market share), and Google (11% market share). Cloud computing offers businesses an opportunity to reorganize their IT infrastructures and decrease their reliance on corporate servers—resulting in overall savings in their IT spending budgets.

This area of the technology industry is "sticky" because corporate customers are not as fickle as retail consumers, who change products in a heartbeat. The "utilitization" of the enterprise cloud business segment is very attractive, as well as potentially very profitable, due to its "tech tentacles" and long-term annuity-like attributes. For example, large organizations are using Microsoft's data management, machine-learning analytics, and cognitive services to infuse AI into their business applications. The far-reaching applications of Microsoft's "intelligent" cloud business include cognitive uses such as vision, speech, and text as well as facial and emotion detection.

Microsoft had another good year of business results in 2023, growing its year-over-year revenues and operating profits by approximately 7% and 6%, respectively. During the past year, a slowdown in the global economy led to less corporate spending, and Microsoft was impacted by the economic downturn. We remain enthusiastic about the company's prospects and expect Microsoft's 2024 revenue and operating profits to grow by approximately 15%. We expect adjusted earnings per share to grow approximately 15.5%, to $11.30 per share in Microsoft's fiscal year-end, June 2024 (the slightly higher increase in per-share earnings is due to expected share buybacks). During the current fiscal year, Microsoft will generate approximately $65 billion of owner earnings and will return a large amount of this cash to shareholders through net share repurchases of approximately $23 billion and dividends of $22 billion. With its consistent return of cash to owners and growing position in the technology industry, Microsoft will remain a long-term position in our portfolio.

Alphabet (Google)

Alphabet is the parent company of Google's growing portfolio of businesses that span several industries including technology, life sciences, investment capital, and research. Google remains Alphabet's largest subsidiary. Google focuses on Internet-related products and services that include internet search, online advertising technologies, cloud computing, and software and hardware development. Google's market share of global online searches exceeds 90% (most people just "Google" it!). The company's meteoric growth since its founding in 1998 has triggered a number of products, acquisitions, and partnerships beyond Google's core search engine. Google offers services designed for work and productivity through Google Docs and email (Gmail), scheduling and time management (Google Calendar), cloud storage (Google Drive), language translation (Google Translate), mapping and navigation (Google Maps/Waze), video sharing (YouTube), and a

multitude of other products. The company also developed the Android mobile operating system (which currently holds more than 70% global market share), the Google Chrome web browser, and Chrome OS, a lightweight operating system based on the Chrome browser that has a large share of the U.S. K–12 classroom laptops and tablets market.

Over the past six and a half years, we have made a significant investment in Alphabet and have continued to add to this position whenever conditions are advantageous. Our original allocation to Alphabet was a transition from our investment in IBM's leading artificial intelligence (AI) computing technology—after realizing we were on the wrong AI horse, we pivoted to Alphabet. We are pleased that we made this adjustment and will maintain a significant position in Alphabet, which we consider to be a long-term strategic holding in our portfolio.

The technology industry landscape has changed dramatically over the past 15 years with the advent of cloud computing, which enabled the emergence and application of cognitive computing and AI. With the exponential rise in cloud computing, massive amounts of data are housed in interconnected computers around the world, and companies seek to transform this information into useful knowledge using various applications and data analytics capabilities. Today's digital intelligence is based on massive data mining and analysis, and increasingly sophisticated cognitive computing capabilities are gaining prominence.

Cognitive computing—the simulation of human thought processes in computerized models—allows for computers to systematically learn—and even teach, to an extent. As technology giants such as Alphabet, Microsoft, and Amazon work diligently to make advanced computer learning a reality in this new environment, AI is fast becoming a reality. We believe that Alphabet has a tremendous opportunity to penetrate the growing AI technology segment as cloud computing and cognitive computing capabilities further develop. Alphabet has been making major acquisitions and investing heavily in cloud computing and AI to compete in this growing market and now has an 11% share of the cloud computing market. This industry space will continue to be a large contributor to future growth, and the Google Cloud Platform provides an avenue for the seamless delivery of Alphabet's products and services to customers.

Why does Alphabet have a tremendous opportunity in the AI space? Cloud service providers such as Alphabet develop algorithms that allow their computers to learn as data continually moves through their networks. The pervasive use of Google's search engine (as well as its other previously mentioned products) enables Alphabet to gather, manipulate, and understand our individual and collective behaviors in a multitude of useful ways. The massive amount of consistently compiled data gives Alphabet an edge in developing AI. Google itself is a learning machine that adapts each day based on the intelligence it gathers. Businesses using Google Cloud have access to immediate software solutions, increased efficiency through data management, and improved operational excellence via AI influence. The information gathered through both individual data (search, health, maps, YouTube, etc.) and through business operations such as Google Cloud allows Alphabet to develop related offshoot businesses as the company scales its learning capabilities. The constant information gathered, coupled with continuous learning, acts as a catalyst to propel Alphabet to develop and compete in emerging markets, such as self-driving vehicles (Waymo), data science and healthcare (Verily), the application of AI (DeepMind) and home security and connectivity (Nest). These additional "bets" are all strategically integrated around Alphabet's most valuable advantage—the information it continuously gathers, continuous learning, and knowledge provided to consumers and businesses using its products and services. The ability to gather information continuously allows Google to learn and adapt instantly to emerging consumer trends and deliver the most user-friendly, consumer-driven search experience on the market. Google's pervasive network of interconnectivity also creates consumer reliance on integrated Google software and hardware that will continue to grow as the company adds products and services in the future.

Obviously, the winners in the AI world will be companies that have the greatest amount of usage and data flowing through their networks, and we cannot think of any company on the planet that has more widespread usage than Alphabet.

Alphabet is an extremely profitable company that produced adjusted earnings of $76.5 billion in 2023. After last year's tepid results due to difficult economic conditions (Alphabet's per-share earnings declined by 3.2% in 2022), the company grew its adjusted per-share earnings by approximately 22%, to $5.93 per-share in 2023. Owner earnings are expected to reach approximately $75 billion in 2024 and—with Alphabet's current market capitalization of approximately $1.75 trillion and removing net cash after debt cash of approximately $100 billion—a buyer of Google is obtaining an approximate 4.5% projected owner-earnings yield that is growing at approximately 14% per year. At the current price, Alphabet continues to provide us with an opportunity to own a great collection of promising enterprises that have high growth potential through expanding service interconnectivity.

Meta Platforms (Facebook & Instagram)

In our 2021 letter, we introduced our latest investment―Meta Platforms (formerly Facebook). Not long after our purchase, the price of Meta's stock tumbled and continued to sink as the 2022 year progressed―falling 64% for the year. When this happens, an investor obviously questions the purchase. What goes around, comes around, however: During 2023, Meta Platforms stock rose 194%, erasing its loss since our acquisition. Although it would be tempting to justify this investment given that it actually outpaced the market since our initial purchase, we realize that Meta's price gyration is still on everyone's' mind. Pain may be a reminder that one is alive, and it may represent one's ability to overcome adversity—but if you're like me, you'd rather skip the experience. With the recovery in "Meta's stock price," however, we should once again articulate our thinking about this investment.

Last year, we examined three aspects of our Meta purchase, given that our allocation of capital to this business was rather large:

1. First, we reviewed the "timing" of this investment—this was obviously poor, given the 64% deterioration in Meta's price during 2022. We concluded that if the price falloff was, in fact, a matter of poor timing, this could be rectified with time as well. (This happened faster than we expected, which was a pleasant surprise.)
2. Next, we reviewed whether we might have miscalculated the value of Meta's business—whether the purchase price we'd paid was too high relative to Meta's intrinsic value. How much of a difference in the price paid vs. intrinsic value is a good question, and we will review this again as well, keeping in mind that the valuation of any business is always a range, as opposed to an exact dollar amount.
3. In our third and worst-case scenario, we considered whether our original investment could have amounted to a "Kodak moment"—a failure to recognize a business that was facing a change that would permanently destroy its value.

Meta: Not a Kodak Moment

In retrospect, we see that Meta was certainly not a Kodak moment: Over the past year, the business achieved profits similar to when we initially purchased the company―and we expect profits to grow in the future. Nevertheless, important questions remain about the aspects of Meta's business that attracted our attention in the first place.

What is Meta's current position in the digital advertising marketplace, and how will this position change over time? According to a Statista Report, Meta and Google collectively controlled more than 50% of worldwide digital ad spend during 2023 (Google had an approximate 39% share, while Meta had an approximate 18% share). Global digital ad spend is projected to grow over the next five years at approximately 5% per year, reaching around $875 billion by the end of 2028. Although new entrants in the digital ad space will certainly have an impact on the Google/Meta duopoly, the forecast over the next five years is for Meta and Google to maintain an approximate 50% combined share of global digital ad spend.

Our conclusion is that Meta (and Google) will be able to increase revenues through their participation in the global growth of digital advertising, despite losing some market share to new entrants grabbing advertising dollars, such as Amazon and TikTok. In hindsight, it is also important to note that Meta's growth in digital

advertising was pervasive the past several years, generating $115 billion in revenue in 2021—up 37% from 2020, on top of being up 22% over 2019. During 2022, Meta was negatively impacted by a reduction in advertising revenue, with a reported digital advertising revenue of $113.5 billion—down approximately 2%. Meta's digital advertising revenues bounced back this past year, however, and is expected to reach around $130.5 billion in the 2023 reported year, representing a year-over-year growth rate of nearly 15%.

Is Meta's user base eroding? In last year's letter, we mentioned that every day, roughly 2.9 billion people access one of Meta's products—Facebook, Instagram, and WhatsApp—while another 880 million log in at least once per month, for a total user base of 3.7 billion. During 2023, these numbers once again increased. The number of people accessing one of Meta's products each day grew to 3.1 billion, while another 900 million log in at least once per month, for a total user base of approximately 4 billion—representing approximately two-thirds of the planet's potential social media users.

Given these facts, last year we emphasized that we did not foresee a cataclysmic end to Meta's social media business and believed that Meta would not be the next Kodak. Rather than simply conclude now that we were correct about this assessment, we'd like to acknowledge obstacles the company still must overcome that will require it to be resilient and adaptable to a continuously evolving social media marketplace. Among Meta's current challenges that we will continue to keep an eye on:

1. **The interaction between users and social media platforms has changed over the past few years and continues to rapidly transform.** Social media participants continue to move quickly from posting text and pictures to posting videos (e.g., Facebook and Instagram Reels). The movement among users from a static to dynamic interface has not only altered user experience but is transforming advertising on social media platforms. During 2023, advertisers and social media platforms have been learning effective methods for attracting and engaging users via their use of video, but there is still room for Meta, as well as other social platforms, to better understand how to further increase engagement between users and advertisers in a high-video-content environment. Meta is making a large commitment to AI to better understand user behavior and to better connect individuals and advertisers to provide consumers "what they want" in their personal ads, but this is a journey, not a destination.

   Video options have emerged on multiple media platforms, and the stage for multichannel video placement presents both opportunities as well as threats to the core Meta franchises (Facebook, Instagram, and WhatsApp.). It is still our assessment that Meta has a unique competitive advantage in this evolving market. The company's multifaceted set of social media properties naturally allows Meta to further connect businesses and consumers as diverse, self-driven video content produced by individuals and small businesses increases engagement among user communities over time.

2. **The impact of Apple's 2021 privacy setting update on social media platforms.** This Apple system update introduced App Tracking Transparency, which requires applications to ask users permission for tracking their activity across apps and websites owned by other companies. This led to many individuals opting out of having their activity tracked, which impacted all social media apps from providing "targeted ads" to users, whereas they had previously been able to track users' activity. As a result, advertisements became more or less "hit or miss," and advertisers had to spend more money on social media sites to attract consumers. While this change affected all social media companies, Meta—as the largest social media company—was impacted the most. We believe, however, that Meta is emerging stronger than other social media platforms in response to this change—the company has made agreements with other social media providers for sharing user data where legally allowed, and Meta has developed sophisticated algorithms to deliver better-targeted ads for advertisers by leveraging AI. Enhanced AI remains a work in progress at Meta Platforms, though these capabilities are always susceptible to competitors producing better AI algorithms that meet the needs of consumers and advertisers.

3. **We still believe that Meta needs to aggressively expand its social media business segments beyond individuals, to include corporations.** Meta is in an unprecedented position to provide large organizations with an exceptional private intranet community through its "Workplace" product, which enhances organizational communication. For many companies, the ability to connect, collaborate, and exchange knowledge instantaneously through Meta's Workplace product will enhance productivity and increase speed of innovation. The Workplace platform is designed to enhance employee engagement and support, information-sharing and feedback, and remote job training.

   We believe that Workplace—currently with more than 7 million users—could achieve significant worldwide usage, with corporations becoming entrenched in a Workplace ecosystem in the future and user engagement augmenting connections within companies in ways that are different from today. For example, Workplace Platforms could help healthcare providers more effectively connect with employees to manage employee health, or investment consultants to assist employees with retirement benefits. As deep roots develop in a Workplace ecosystem, this product could serve as a future annuity to Meta—offering large corporations cloud services, data analytics, and AI for effective decision-making throughout their organizations. In addition, with emerging data analytics and AI technology, Meta would be positioned provide a unique capability to match suppliers to corporations and to assist in inventory management, logistics, and the development of an overall community of partnerships.

   In summary, an emphasis on creating a large business community network through Workplace would permanently cement Meta's place within the global business ecosystem. It would also create an annuitized revenue stream through business subscriptions that would complement the core Meta consumer applications that are highly reliant on advertising and subject to ongoing competition.

4. **All social media platforms will evolve in the future to include Augmented Reality (AR) and Virtual Reality (VR).** Although this area that Meta emphasized a few years ago—which led to the company's name change—has somewhat receded into the background in the past 12 months, it is not going away; therefore, we'd like to provide some context about the metaverse and its future.

   The virtual world envisioned by most people is created through the concept of virtual reality (VR) technology. But there is more to the metaverse than VR, including augmented reality (AR). While VR creates an immersive "virtual environment," AR augments a "real-world" scene. In essence, VR is 75% virtual, while AR is only 25% virtual. VR requires a headset device, while AR does not. VR users move in a completely fictional world, while AR users are in contact with the real world.

   What does all this mean? The metaverse as a mechanism for individuals to seamlessly connect in a virtual world is going to take some time to realize, while the capabilities for individuals to connect in an augmented world will be here within the next five to seven years. Think of connecting immediately with a friend or viewing driving directions through the corner of your glasses (or on your windshield), as opposed to looking down at your phone. Or imagine a surgeon being able to use AR glasses to connect remotely with another surgeon to guide him through a complex procedure—while they're both viewing the same patient in real time. These concepts are part of a metaverse that is just around the corner, and Meta (along with organizations such as Apple and Google) are currently working on devices to deliver these capabilities.

   In summary: The future of the metaverse has yet to be fully defined, but we can appreciate now its potential to grow in importance as the technological capabilities that will enable social interaction in multidimensional settings emerge. Meta's desire to control the major platform in which the metaverse exists—before another organization such as Apple gets control—is understandable. We

recognize, however, that the metaverse envisioned by most people will take years to fully develop. A robust VR environment that seamlessly connects many participants will require trillions of dollars in investment in improved broadband capability, computing power, hardware, software, and other considerations. Ultimately, the architecture for a VR metaverse will naturally evolve in concert with infrastructure development—for example, 6G and quantum computing.

Meta: Miscalculated Value?

When we originally purchased Meta in 2021, we compared how Meta traded at a discount relative to the overall market—at the time, the S&P 500 index was trading at around 20 times 2022's expected earnings, depending on one's estimate. With Meta's 2022 earnings projected to exceed $14 per share and a long-term growing franchise, Meta was trading at a very similar valuation multiple to the market, including the extra cash sitting on its balance sheet. In other words: Even though Meta was a far-above-average company when measured against every business metric imaginable, investors were not willing to pay a dollar more for its fast, growing earnings than they would pay for the composite of all major U.S. companies. The situation reminded us at the time of an excerpt from a 1929 *New York Times* article describing Albert Einstein's view of relativity:

> *When you sit with a nice girl for two hours you may think it's only a minute, but when you sit on a hot stove for a minute you think it's two hours. That's relativity.*

Clearly, we sat on a hot stove with Meta throughout 2022 as the company stock price fell like a rock from the top of a 50-story building. Meta's earnings per share during 2022 turned out to be $8.59 per share, rather than the expected $14 forecast. Aa a result, the 12 months of 2022 felt like an eternity.

Putting aside any relative comparisons: We conclude that we did make a miscalculation in our value of Meta in 2021. Meta's financial performance of previous years reflected a business experiencing high growth and pre-tax profit margins that hovered between 35%–40%. But Meta's recent large spending of $15 billion per year to gain a toehold in the emerging metaverse, coupled with its consistent large investment in data centers and emerging AI technologies, amounted to Meta spending around 30% of revenue on research and development. (It is worth noting that Meta's R&D investment as a percentage of revenue is more than twice that of Alphabet and Microsoft—and still is.) This outsize spending led to a profit margin compression at Meta, where pre-tax profit margins were lowered to approximately 28%—around 25% less than they had been previously. Meta's slightly lower revenue in 2022, plus enormous incremental spending, had negatively impacted profits and cash available for shareholders—leading to a lower value.

We have stated many times that the intrinsic value of any business is correlated to the discounted value of the cash that can be distributed to owners during its remaining life. This is the only true way to value a business asset. While Meta had continued to deliver a high level of free cash flow that was distributable to shareholders—despite spending enormous sums of money to build out its business to accommodate future growth—at the end of 2022, calculating 25%+ less cash per year being produced at Meta than had been previously expected to take place between now and its remaining business life commensurately lowers the company's value as well. If Meta had continued to spend enormous sums of cash on future projects, creating an essentially permanent state by which 25%+ less cash could be distributed to its owners between now and kingdom come, then the calculated intrinsic value of Meta would be a lot more than 25% less than what was originally anticipated. In summary, unless Meta changed its negative revenue/higher expense pattern, we would have overpaid for the business.

Moving to today: In the past year, Meta executed a significant slowdown in its spending and implemented layoffs of more than 20,000 employees. In addition, revenues rebounded by about 15% during this time frame, as advertising improved. This higher revenue/lower expense equation substantially increased cash available to shareholders, increasing Meta's intrinsic value during 2023. Investors reacted enthusiastically to this large value adjustment and drove up Meta's stock price to a point at which the company's market capitalization is approaching its level of several years ago. We stated in last year's letter that Meta's low valuation by the market seemed extreme, and that we had no intention of selling Meta at its price at the time. Given Meta's adjustments to its business operations, along with developments in social media and AI that have greatly

improved the company's advertising model, we plan to maintain our position in Meta for the foreseeable future. A word of restraint: We believe that Meta is currently trading at around its intrinsic value and will grow in the future based on its ability to successfully adapt, as well as monetize, their services in the ever-changing social media space.

In last year's letter, we discussed how news outlets such as the *Wall Street Journal* and *60 Minutes* cover Meta platforms on an almost-constant basis. Social media platforms continue to spark news stories regarding their impact on society, especially on young adults. As the largest social media platform, Meta is regularly highlighted in news coverage about social media's negative influence on young adults, focused on topics such as cyberbullying, inappropriate content, misinformation (fake news), social media addiction, and how both young and older adults are contending with self-image issues and developing social anxiety through extreme usage of social media. These issues must be addressed, since social media platforms are not going away. The U.S. government will (and should) take action to create "rules of the road" as well as restrictions on social media companies' activities in the future. We are on board with the establishment of regulatory guardrails for all social media companies, similar to regulations established over the past century regarding content in media outlets such as television, radio, and movies.

Meta already has tremendous scale in the media ecosystem that the government (and Meta's competitors) would find difficult to duplicate. Meta has invested billions of dollars to tackle harms that can befall users of its platforms, including the recruitment of more than 40,000 people to work on safety and security and employing more than 15,000 content moderators. The company is making tremendous strides in working in tandem with highly refined AI servers that moderate text, video, links, updates, photos, and file uploads of nearly half the world's adult population. This is an enormous task that will continue, but achieving meaningful control over any social media ecosystem without regulations and standards in place is nearly impossible. While Meta's failures are criticized (fairly) at times, we continue to ask: If not Meta, who will take on this task? Who else has the scale, the experience, the incentive, and even the desire to do the job? Mass online social sharing is here to stay; the only question is how it will be managed by social media platforms, governments, parents, and individual users.

On the other side of the fence, Meta is also heavily criticized for *too much* censorship. Managing social media content is a tough balance for any company, let alone one serving dozens of cultures around the world, all with different ideas of what the "proper" level of censorship should be. Eventually, social media engagement rules will need to be established by governments throughout the world and adhered to by social media participants within each respective country.

We do believe that Meta cares deeply about content moderation and that it is a victim of its own success—its ubiquity is so overwhelming, and its products so conducive to human proclivities (positive as well as negative), that problems are inevitable. But we also believe that Meta is the only company with the scale, skill, desire, and technical talent to handle the problems inherent in social media, and so we believe that its competitive position is strong—and here to stay.

FINANCIAL SERVICES GROUP

Berkshire Hathaway

Berkshire Hathaway had a very good year, with its various businesses gaining ground during 2023. Berkshire's unmatched diversity, strength, and predictability act as ballast that allows the enterprise to be resilient and adapt to changing economic conditions.

Warren Buffett's holding company is extremely diverse, with massive operations in insurance (including Berkshire Hathaway Reinsurance, GEICO, National Indemnity, and General Reinsurance), railroads (the BNSF system), heavy industry (Precision Castparts), utilities (Berkshire Hathaway Energy), portfolio management (an approximately $350 billion equity securities portfolio, of which about 45% is Apple stock), and dozens of smaller services and industrial businesses that collectively make up another large portion of

Berkshire's value. Berkshire's total assets are valued at approximately $1 trillion, and the company holds more than $525 billion of shareholders' equity—the largest for any publicly traded corporation in the world.

Although Berkshire's financial performance in 2023 improved since the previous year—when slowing business activity within its owned businesses impacted results—in contrast to 2022, the company did not put a large portion of excess capital in the stock market to enhance future returns. During the market downfall of 2022, Warren Buffett purchased more than $50 billion of equities, while in 2023, he sold more than $20 billion of equities from Berkshire's portfolio. As a result, Berkshire will end the year with more than $155 billion of cash and short-term investments in U.S. Treasuries, an increase from approximately $110 billion of cash and cash equivalents on its balance sheet at the end of 2022. At the time of this writing, the cash and cash equivalents on Berkshire's balance sheet represent an amazing 20% of the company's total market capitalization. The only consolation to this large cash and cash equivalent holding is the opportunity to earn more than 5% annually—or $7.5+ billion per year—on this dormant capital.

At the end of 2023, Berkshire is expected to report an increase in its per-share book value, up 12% over the preceding 12 months. During 2023, Berkshire was able to repurchase around $7 billion of stock, reducing its share count slightly more than 1%. What is more noteworthy about Berkshire Hathaway is the fact that the company's tangible book value per share has grown an astonishing 12% per year over the past six years. This is an amazing feat, given the size of Berkshire's expansive enterprise. Warren Buffett continues to create tremendous shareholder value through the prudent allocation of capital, enhancing shareholders' interest in owning this wonderful company.

Charlie Munger, Warren Buffett's partner for more than 60 years, passed away on November 28 of this year, just shy of his 100th birthday, which would have taken place on New Year's Day. To say that this event will not be an appreciable loss to Berkshire Hathaway due to Warren Buffett's ongoing leadership would be a mistake. It takes more than one person to build a company, and Charlie Munger was an important sous-chef who contributed unique ingredients to the special sauce that led to Berkshire's success.

The loss of Charlie Munger naturally leads us to reckon with the thought of the inevitable passing of the Berkshire torch to the next generation of managers. We believe that Warren and Charlie will be a tough act to follow, and we are actively attempting to construct a realistic vision of Berkshire's future under new leadership. This picture is still developing and currently remains a bit cloudy; it probably will not become clear until we witness new individuals truly managing the company. The passing of Charlie will likely put emerging managers on display as they step up to take a greater leadership role in the company, and we will be carefully evaluating their capabilities to create value for Berkshire shareholders. We believe that Warren Buffett understands these issues now more than ever and is evolving Berkshire's team to address an eventual passing of the management torch.

Warren remains healthy and fully engaged in the company. Under his continued leadership, we believe that Berkshire is capable of growing its current enterprise between 3%–4% per year from the development of its underlying business, while share repurchases and/or any future acquisitions (both marketable securities and whole businesses) should add at least another 5% per year—for a total return of 8%–9% per year over the next five years. If Berkshire's company valuation holds steady relative to its growing book value, shareholders should receive similar returns. Of course, this is a guesstimate based on the facts we have available today, and we will continue to update our understanding of the company's position as new information comes to light.

In summary, Berkshire remains a fairly valued investment growing at an above-average rate (on a per-share basis) and remains an allocation in which we have a low chance of permanent loss among any assets we currently own (or can contemplate owning) in today's market.

Wells Fargo

Over the past few years in our annual reports, we have discussed the main issue Wells Fargo and other banks have been confronting: The continuing compression of interest rate spreads (i.e., net interest margin, or NIM), which is an all-important ingredient for bank shareholders. The greater the spread between the money earned

on invested bank assets vs. the cost of these same funds, the more money the bank makes. For example, at year-end 2021, Wells' NIM finished at a multi-year low of 2.05%. This compared to 2.28% and 2.73% in the years 2020 and 2019, respectively. This noticeable compression in Wells' NIM compressed bank earnings and, ultimately, its value. Here's the good news: With rising interest rates over the past few years, Wells Fargo's NIM jumped to 2.63% at the end of 2022 and further increased to 3.1% in the first nine months of 2023—we continue to watch an upswing.

To appreciate the impact of the NIM on a bank's earnings, consider that the difference between a 2.0% and 3.0% margin on Wells Fargo's $1.73 trillion in interest-earning assets is around $17 billion per year pre-tax—all of which would be incremental profit to the company after paying taxes. Of course, there's a lot more to the earnings quotation of a large bank such as Wells than its NIM. The bank's non-interest income and expenses are also important, and these continued to be impacted by the ongoing business slowdown in 2023. For example, while deal activity remained steady—which led to a slight increase in advisory fees—mortgage banking fees further decreased as mortgage activity continued to drop due to rising interest rates.

A final consideration: Wells Fargo remains in the crosshairs of past regulatory issues, and the company needs to finish dealing with these ongoing challenges. Progress on this front has been slower than we'd anticipated, delayed by the complexities of running a large banking institution as well as the inability of management to get Wells Fargo's systems and processes up to date and in acceptable shape for regulators to feel comfortable that its past transgressions won't be repeated. While this remains an ongoing process, we are confident that the organization is moving forward with a strong focus on cleaning up its regulatory issues, and we are hopeful that it will be out of the regulatory woodshed within the next few years. At that point, Wells can grow again. It has been a long road for Wells Fargo in dealing with the banking regulatory authorities, who have been harsh in their use of Wells to emphasize to other banking organizations how to deal fairly with consumers.

We will remain patient during Wells Fargo's challenges. The core metrics that create bank profitability remain solidly in place at Wells. The bank has maintained its massive deposit franchise (consumers have not left the bank), and the company has the capability to grow in the future, adding value to shareholders in the upcoming years.

In the meantime, Wells Fargo continues to buy back its own shares with the excess capital released by its restricted growth. Over the past six years, the company repurchased approximately 1.25 billion shares, which represents more than 25% of outstanding shares. At the same time, Wells continues to pay dividends to shareholders equal to 2.84% of the company's year-end share price. Shareholders are receiving a total pass-through yield on their investment in Wells that equals approximately 8.5%.

In summary, we anticipate that Wells Fargo will clear up its regulatory challenges over the next several years and will continue to reduce costs. These actions, coupled with an ongoing rebound in Wells NIM, should allow the bank to increase profits. With a mix of higher profits, a much-reduced cost base, and lower share count, Wells is positioned for an increase in earnings per share and, potentially, a higher stock price. As long as these dynamics are in play and the stock price remains rangebound, we are willing to be patient with Wells' new management as it works through the complex issues it inherited.

American Express (Don't Leave Home Without It)

Our third-largest financial services investment is American Express (Amex). We began purchasing Amex in 2015 and largely completed our investment in this company with additional purchases during 2016—though we continue to add to our American Express holding when we believe the difference between the company's stock price and intrinsic value becomes wide. Although the pandemic severely curtailed travel in 2020, the revitalization of travel and consumer spending in the back half of 2021 and throughout 2022 produced levels of revenues that significantly exceeded pre-pandemic levels. During 2023, Amex's revenue growth continued, increasing around 14% from 2022, with per-share profits equally increasing by the same percentage. We expect the company's revenues and per-share profits to continue their upward trajectory in the coming years.

Many know that the American Express Company’s principal products and services include charge and credit payment card products as well as travel-related services offered to consumers and businesses around the world. The company's full range of products and services goes well beyond charge and credit payment card products and include network services; merchant acquisition and processing, servicing, and settlement; marketing and information products and services for merchants; fee services, including fraud prevention services and the design and operation of customer loyalty and rewards programs; expense management products and services; merchant financing products; travel-related services (including traveler’s checks); and stored-value/prepaid products. American Express products and services are sold to diverse customer groups that include consumers, small businesses, mid-size companies, and large corporations.

American Express is truly a one-of-a-kind company that enjoys a unique credit and charge business based on a “closed-loop system.” The simplest way to explain Amex’s closed-loop system is to describe its opposite—i.e., an “open-loop system,” which is how Visa and MasterCard operate. Visa and MasterCard clients are primarily banks and financial institutions, known as issuers, that issue cards to their customers displaying the Visa or MasterCard logo and bearing all risks associated with the extension of credit. When a cardholder uses a Visa card to purchase goods or services from a merchant—let’s say a store—information is sent via Visa's network to the merchant's bank, known as an acquiring bank. The customer’s card-issuing bank pays the merchant’s bank through the network, which then pays the merchant. The card-issuing bank then sends a monthly statement to its customer for all charges incurred during the period and may earn interest from the cardholder on any outstanding balance the customer does not pay immediately. The issuing bank may also charge the customer a fee for the use of its credit card. Also, the issuing bank earns an interchange reimbursement fee from the merchant’s bank, which charges a merchant discount fee for handling the merchant transaction. Visa participates in this network exchange by charging data-processing fees and service fees to its financial clients but is not involved in lending money. Thus, unlike an issuing bank, Visa is not exposed to any credit risk and earns revenue on the volume of transactions carried out through its associated cards. Leaving aside all this transaction complexity, all we need to remember about the open-loop system business model is that it involves five separate parties that all receive a portion of the financial benefit for each transaction.

In contrast, using a closed-loop system, American Express acts as both the issuer and the acquirer by issuing its own cards through its banking subsidiaries. The company’s primary source of revenue is the discount fee it charges merchants that accept the American Express card (Amex’s merchant fees are usually higher than those of other financial institutions, and we will explain why later). These fees are charged as a percentage of the charge amount processed for the merchant and account for greater than 50% of the company’s total revenues. American Express may also generate revenue from interest earned on loans that are issued to cardholders, from cardholder membership fees, and from travel services. Unlike the Visa and MasterCard model, the American Express revenue model does not depend on the volume of transactions processed but focuses on the total amount spent by each customer. Thus, American Express employs a “spend-centric” business model, attracting affluent customers who are likely to spend more than average.

The American Express Competitive Advantage

In addition to its use of a single closed-loop system, American Express holds a dominant market share of major corporations’ travel and entertainment expenditures. This requires an explanation that also demonstrates how the closed-loop system plays a crucial role.

Large corporations bid out the management of their travel and entertainment budgets to travel management companies, and American Express is by far the largest in the world. Amex supplies travel and entertainment management systems to its large corporate customers that encompass travel planning software as well as travel and entertainment payments, including expense reporting. As part of their travel policies, corporations require employees to charge all business-related travel and entertainment expenses on their corporate-issued American Express cards. Because American Express has a dominant market share of travel management systems used by major corporations, travel and entertainment entities that wish to serve corporate clients—including restaurants, hotels, car rental companies, and airlines—must accept the American Express card. Imagine a large corporation’s salesperson taking prospective customers out for dinner and presenting a corporate-issued

American Express card for a large bill—and being told that the restaurant doesn't accept the American Express card. For obvious reasons, this scenario is a rarity. American Express leverages this advantage by charging merchants more for accepting the American Express card. This issue is a longstanding "bone of contention" between merchants and American Express—and a difficult one for merchants to negotiate, since American Express dominates the corporate travel industry.

American Express developed the closed-loop system as a way to optimally serve its base of corporate clients that require effective management of large corporate travel and entertainment budgets. The American Express system collects all travel and entertainment information, which positions American Express and its corporate customers to jointly negotiate discounts for airfares, hotel, and car rental rates, etc.

American Express' competitive advantage lies in the company's unique ability to assist the corporate customer segment with a travel and entertainment expense management system that is unmatchable. The company's wide-ranging closed-loop network is unique in this realm and will continue to provide a competitive advantage as social media evolves and targeted advertising to corporate customers in a mobile world becomes more prevalent. This one-of-a-kind business model will continue to serve as a broad-based platform for consumers, merchants, and future partnerships like no other product.

The benefits of Amex's closed-loop system are not limited to providing major corporations exceptional management of travel and entertainment expenses. This special business system also serves small and midsize companies by providing a different and unmatchable supply-chain management-expense control system. The American Express card for small and midsize businesses leverages the closed-loop system to tie in a company's suppliers (for inventory and payables) as well as its customers (for receivables). The way it works: American Express has an extended merchant network that includes many different suppliers and small businesses that purchase from each other, which then sell to large corporations that already are part of the Amex network. Deploying emerging data analytics and artificial intelligence technology, American Express is able to provide a unique capability that matches suppliers to corporations and assists in inventory management as well as cash management—offering additional terms, as well as benefits, to suppliers and corporate customers. Amex can also leverage the knowledge/information generated by its extended network to negotiate discounted rates on various supplies that small companies may not be able to achieve on their own.

It is our opinion that American Express is not (and never has been) just a "card company" that serves the masses. Amex leaves the chase for low-producing, price- and credit-sensitive consumers that are not brand-sensitive to banks that have a desire to create scale primarily by lending to lower-quality, fickle consumers (most consumers in this segment seem to trade credit cards like we used to trade baseball cards). American Express has an ongoing opportunity to cross-sell and increase its share of customer financial transactions through additional cards it issues in the growing high-end consumer segment. This niche opportunity will continue to develop for many decades as the percentage of "wealthy consumers" grows globally.

American Express produced around $8.25 billion of net earnings in 2023, or $11.22 per share—representing an increase in earnings per share of approximately 14% compared to 2022. During 2023, the company increased its dividend by 15%, distributing more than $1.75 billion to shareholders. American Express also continued its stock repurchase program, buying back more than $3 billion of stock during the past 12 months—creating value for long-term shareholders. Overall, in 2023, Amex's business continued to grow in a challenging economic environment, giving us confidence that American Express will continue strengthening its franchise throughout the world. With American Express' tremendous future in a global marketplace in which cash sales are diminishing, higher-income consumers are increasing in number, and corporate productivity pressures are mounting, we remain enthusiastic owners of this great franchise.

RETAIL GROUP

Our major retail holding—Home Depot—had a tough 2023 as consumers continued to reduce their spending in a high-interest-rate environment. Unfortunately, given the continued economic challenges expected in 2024, we expect revenue and earnings for Home Depot to remain rather static next year. Nevertheless, we anticipate continued growth for Home Depot in the future, along with a long-term expansion of intrinsic business value

that will ultimately be reflected in the company's stock price, despite the temporary setback of the past few years. We plan to remain owners of this great retail business and are confident about Home Depot's growth in intrinsic value as its unique franchises continue to execute on the four essential elements of retail success:

1. **Excellent customer service:** If potential customers walk into your store and get a whiff of poor customer service, they will likely turn around and shop elsewhere. Customer service is paramount in the retail business and not something any retailer can compromise on.
2. **Product selection and superiority:** A retailer must constantly ensure that it is offering the right selection of products at the best possible price. You can provide a great service to your customer with attentive associates and a wonderful retail atmosphere, and then deliver a disservice by stocking the right products at the wrong price, the wrong products at the right price, or—worse yet—the wrong products at the wrong price.
3. **Value creation:** It is tough—perhaps very tough—to make money in retail. A robust understanding of product turnover, day-to-day revenue and expense management, and long-term capital allocation decisions all play into successful value creation.
4. **How to blend one's "bricks and mortar" offering with the new "online channel":** Interconnected retail continues to be a growing dimension of this industry. Successfully integrating the in-store and online customer experience is essential to creating customer and company value.

We have stated in the past how retailing has many moving variables that require tending each and every day. Inattention to any of these details leads to self-destruction—for example, Sears, JCPenney, and many other retailers have all gone through bankruptcy, and two struggling retailers that we pointed out last year were facing imminent bankruptcy—Bed Bath & Beyond and Rite Aid—both succumbed to Chapter 11 bankruptcy in 2023. Retail is a ruthless business, and investors must be careful when swimming in retail waters.

Home Depot

Home Depot faced a challenging year as consumer spending waned on home improvement. After several years of robust growth during 2020 and 2021, when Home Depot posted a nearly 20% and a 14% increase in sales, respectively, the company encountered headwinds the past few years of price inflation and higher interest rates, which decreased large consumer expenditures for home projects. As a result, Home Depot posted tepid sales growth of 4% in 2022 and a 3% decline in sales during 2023 that led to a per-share earnings drop of approximately 10%, from $16.69 to $15.09. Unfortunately, consumer demand for home improvement projects is expected to remain dormant in 2024, and per-share earnings for Home Depot will likely increase slowly to $15.65, mostly due to forecasted share repurchases.

Although Home Depot is facing continuing headwinds, we believe the company will continue to benefit over the long term from a number of trends in its sector and in the country. According to Statista, home improvement spending in the U.S. is currently around $550 billion per year and is expected to reach $620 billion by 2026, increasing at a steady rate of 4%–5% annually. Home Depot and its competitor, Lowe's, capture the dominant share of this spend through their massive, well-located warehouses in nearly every community of size in the U.S., collectively accounting for nearly $240 billion of revenue in the U.S. home improvement sector in 2023. Home Depot and Lowes continue to maintain their respective market shares, and it wouldn't surprise us if those shares continued to increase as Home Depot and Lowe's implement contractor-friendly "Pro" programs that seek to grab business from smaller independent players across the country in categories such as lumber, tools, paint, and dozens of other products contractors and homeowners need daily to keep our homes and buildings in shape.

Home Depot's competitive advantages provide a wide and deep moat around its retail castle. The company has purchasing scale that cannot be matched in all key home improvement categories—hundreds of thousands of contractors and millions of do-it-yourselfers habitually visit Home Depots every year, and the company has large physical footprints (both its retail locations and its massive central distribution warehouses) that distribute lots of large, heavy, and "needed-on-demand" types of products that are not easily distributed by

aggressive general merchandise e-tailers like Amazon. Where else can one obtain 10 gallons of paint, a pile of 2x4s, a miter saw, a light fixture, and a candy bar in one place, at a fair price, and with guidance from an expert?

We believe Home Depot has a long and bright future ahead for its unique business. Nevertheless, we'll be keeping an eye on several issues:

1. Unless the company decides to make a large international push—typically very difficult for physical retailers—Home Depot will be restricted to slower growth by taking an increasing share of just the U.S. home improvement market, along with Lowe's and smaller players like Tractor Supply and Floor & Decor.
2. Home Depot operates at the whims of the housing market, which is currently impacted by higher interest rates that have led to higher mortgage rates for home buyers. As a result, housing starts decreased 18% from 2022 to 2023, from 1.55 to 1.27 million units—the level of new residential construction in 2018-2019—and housing starts are currently forecasted to remain at this level in 2024. Despite this temporary setback, we expect housing starts to rebound in 2025 as inflation moderates, interest rates and mortgage rates decline, and home prices become more affordable. We should then see home price appreciation returning to a long-run annual increase of 3%-4% and repair/remodel spending normalizing at a 5% annual rate of growth.

Owing to the slowdown in home improvement expenditures over the past few years, Home Depot's valuation and stock price have remained flat during this same time frame. Although investors should temper any expectation of Home Depot repeating the significant growth the company experienced during the first years of the pandemic, when home improvement projects proliferated during the stay-at-home era, we believe Home Depot's substantial competitive advantages, continued growth, excellent management, and "fair" valuation will provide investors fair returns over time.

MEDIA & ENTERTAINMENT GROUP

Media and entertainment businesses continue to be a challenging investment area. The industry remains extremely competitive and dynamic due to its exposure to changing technology infrastructure, including a large disruption in distribution as content producers go direct-to-consumer through "streaming" while consumers "cut the cord" and forgo traditional cable providers. Considering the vast and growing number of platforms available for content distribution and the multiple channels through which consumers can access entertainment, creating and distributing "great content" to attract customers and advertisers is paramount for media companies. We know of no other business in which a customer or advertiser can switch loyalty as quickly as in the media business. In addition, an ever-accelerating migration of advertising revenues into emerging new media companies continues to increase due to the disruptive streaming content offerings in this industry by companies like Amazon Prime, Netflix, Apple, Hulu, and YouTube. As a result, over the past few years, several legacy media companies that rely on advertising revenues to drive profitability continued to struggle with stationary to negative comparative revenue and earnings. Clearly, it is important to choose media companies that have a special grip on the marketplace by offering exceptional content that continuously attracts a range of advertisers and consumers, despite the disruption created by services such as Netflix and Amazon Prime. In this category, we continue to hold what we consider to be the best long-term media business in the industry: Disney.

The Walt Disney Company

Disney remains a media business that we place in the long-term "invaluable" category due to its unique franchise. The invaluable nature of Disney is based on its different and unmatched content (films, characters, etc.) that is analogous to an oil well that keeps producing indefinitely after incurring an initial development expense. Each time the company develops an animated or iconic film, much of the film development is expensed at the time of its introduction. When the company re-launches its classic productions in updated

formats—such as the CD format of the past, the streaming service (Disney+) of today, or 3D virtual reality in the future—the company attains additional revenues and profits without incurring the original development costs. We refer to these re-launches from the company's film library as "accessing the Disney vault." That the content of this vault consists of gooses rather than golden eggs is an important investment point—the magic gooses keep laying golden eggs—e.g., *Snow White and the Seven Dwarfs, Pinocchio, Bambi, Cinderella, Alice in Wonderland, Peter Pan, The Little Mermaid, Beauty and the Beast, The Lion King, Aladdin, 101 Dalmatians, Frozen,* etc. We can envision our grandchildren's grandchildren watching many of these classic Disney films in the new millennium, adapted for viewing on whatever happens to be the channel or medium of that future time. The value of the Disney vault is incalculable because of the 100-year annuity associated with producing iconic new films as well as reissuing previous Disney films as novel delivery mediums emerge and as new generations of children—future viewers of these movies—are born each day.

The Walt Disney Company has had a couple of very challenging years. During 2022 and 2023, media companies vied for consumers' attention by delivering (and spending heavily on) original streaming content. Disney was no exception, as while the company's direct-to-consumer initiatives such as Disney+, Hulu, and ESPN are major drivers for the company's long-term growth, the cost of developing leadership in a new direct-to-consumer channel requires heavy investment. Although Disney's streaming service subscriber base will continue to grow throughout the world in the future and consumers will continue to benefit from new Disney-created content (along with access to the company's deep franchise library of classic content), Disney's current development costs and investment in streaming services is large, impacting its profits.

With the focus on streaming development, Disney's previous CEO, Bob Chapek, was thought to be neglecting other key areas of Disney, such as creative content and parks. As a result, toward the end of 2022, Disney's board of directors removed Bob Chapek and rehired Bob Iger, who had retired as Disney's CEO just 12 months earlier. Bob Iger has been back at the Disney helm for 14 months now, and the challenges in the company have turned out to be greater than anticipated, in large part due to a continued consumer movement to consume content through streaming as opposed to attending traditional theatrical movies.

With the return of Bob Iger as Disney's CEO, the company's aggressive focus on advancing Disney's streaming platform is being scaled back a bit to improve profitability. In line with Mr. Iger's past leadership at Disney, we expect the company to maintain a balanced focus: Expanding its invaluable library of content, broadening its distribution network, and embracing new technologies that complement and enhance the Disney experience. Achieving this balance will be a process, however, and although a turnaround is clearly evident in the company's recent results, it will take several years for Disney to get back on track.

In its fiscal year 2024, we expect Disney to grow revenues by approximately 4.2%, approaching $92.5 billion. Annual profits will likely increase significantly, from $5.4 billion to $8 billion, as the company continues to focus on increasing its bottom line. Given Disney's renewed attention on profitability and balanced investment in its future, we remain long-term shareholders of Disney. We believe the company's broad range of content offerings, growing international presence, and broad distribution capabilities will allow the company to extend its global reach for many years to come.

FIXED-INCOME INVESTMENTS

The Barclay's U.S. Aggregate Bond Index, which represents the broad debt market, experienced a 5.53% gain in 2023, recovering slightly from a 12.7% loss in 2022. Many will be surprised to learn that an investment in the aggregate fixed-income market over the past three years suffered a cumulative loss of 9.5%, while a similar investment in the S&P 500 stock market index achieved a cumulative gain that exceeded 27.5%—and bonds were thought to be a safe haven from a falling stock market. In evaluating the current fixed-income market, we remain extremely cautious about any long-term investment in most forms of fixed-income securities. Stepping back and looking at fixed-income investments in a similar manner to investing in a business would make anyone skeptical about their prospects for future returns.

Let's say that a business with zero debt is able to produce a steady 10% return on equity. If management elects to retain the annual earnings of this business and plow the funds back into the company, investors can expect to see their "equity bond" double in a little more than seven years.

Now let's look at a bond through a similar business lens. If you purchase a bond at par that produces a 10% tax-exempt coupon and choose to retain the annual earnings from this bond and reinvest the money into the same bond at par each year, you will also double your money in a little more than seven years—producing a similar result to our business example.

Based on this example, it is our opinion that people purchasing bonds today are still not applying a business perspective, despite the rising interest rate environment. For example, putting aside tax implications, if we purchased a 30-year U.S. Treasury bond today at an approximate 4% annual yield and chose to reinvest the coupon payments into those same bonds at par, it would take around 18 years to double our money. If we presented our clients with a similar arrangement to invest in a business at book value that produces a 4% return on equity and retains all the proceeds to repeat this poor return, our judgment would justifiably be questioned, regardless of whether the business was assured survival. Unfortunately, today's low return of 4% on a 30-year U.S. Treasury bond will only slightly exceed long-term inflation. Nevertheless, many financial advisors and individuals who adhere to traditional rules of portfolio construction are placing an inordinate percentage of assets toward long-term fixed-income instruments. Allocating large sums of money to *u*nbusinesslike opportunities may lead to further stress on long-term portfolio returns. We believe that the current long-dated bond market remains too high, especially when the Federal Reserve is conservatively managing short-term interest rates that currently exceed 5% to combat inflation.

We continue to emphasize several points that concern us about fixed-income instruments: Besides the lower-than-average yield being offered on long-term government bonds (the average yield on a 30-year U.S. Treasury bond has been approximately 6% over the past 50 years), looming risks associated with this "secure investment vehicle" include long-term interest rates eventually rising further over the upcoming decades, negatively impacting this secure bond's current value. For other fixed-income investments that are priced competitively against long-term government risk-free bonds, there is an increased probability of default by many entities that are now laden with debt as a result of increased borrowing during a low-interest rate environment. These entities will have to refinance their current debt at higher interest rates once their low-interest debt matures, putting tremendous pressure on their ability to service debt. Thus, we remain concerned about low long-term market interest rates—which will continue to be susceptible to further upward movement, based on the Federal Reserve's direction of maintaining a higher interest rate environment—until inflationary conditions normalize.

In 2024, we have small tranches of fixed-income instruments coming due and believe that the best opportunity for placing fixed-income funds is currently in short-term U. S. Treasuries earning a greater than 5% annual yield. We will seek to reinvest the proceeds in fixed-income instruments where we can find worthwhile securities that will provide a fair return. We will continue to maintain a businesslike attitude about our fixed-income investments, carefully allocating money to securities that offer a fair risk and return over the duration of the holding.

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WHAT'S NEW AT FOUNDERS?

During 2023, Founders associates continued to work closely together, demonstrating the same level of care for others as they do for themselves. This "others-centered" vs. "self-centered" mindset permeates Founders, and we are proud of the special culture in which we operate.

Transparency will always be paramount to the success of any partnership, and we remain committed to communicating openly and fully with our clients and with each other. At Founders, each year we share a greater portion of our duties within the firm, allowing everyone to interconnect and grow in their responsibilities. In 2023, we also made internal progress in our efforts to develop great capabilities to serve clients.

In 2023, Anna Case and Ted Terrion obtained their Certified Financial Planner (CFP®) Certifications. The preparation program for becoming certified as a CFP requires between 18 months to two years of study (Ted and Anna completed their study program in one year) and culminates with a national test that takes roughly six hours to complete. Intensive studying undertaken by individuals preparing for the CFP exam notwithstanding, only 60% pass. In short: It is a grueling process. Why complete this arduous task? Pursuing the CFP designation was necessary for Founders to grow our offerings in estate management and multigeneration asset protection. We have expanded our knowledge and activities in these important areas as part of our ongoing commitment to increase our capabilities to assist clients in specific domains and to offer the highest level of service that our clients, and we, expect.

Our increased involvement in working with multigenerational assets has led us to expand our family office service offerings, including evaluating family business arrangements, consulting on private capital investments, family banking that includes arranging family loans and mortgages, etc. We consider these activities to be part of Founders' core mission to provide premier capital allocation services to our client partners.

Anna has done yeoman's work this past year, working with more than a dozen families to manage and update their estates—coordinating with estate attorneys to properly label assets, map estate distributions, evaluate multiple trusts, and ensure that beneficiaries are correctly outlined. She also completed family mortgages, managed lease-back contracts, and evaluated various outstanding annuities. Needless to say, Anna was busy this past year, and I hesitate to mention that if anyone needs estate consultation, please give Anna a call.

Lisa Wackerman continues to be the backbone of Founders' operations and regulatory compliance program. She also manages financial matters with clients, and we thank her for the seamless execution of many duties that fall under her purview—including client accounting, cash management, and charitable activities. We would be lost without Lisa and are grateful for her dedication to Founders and our clients.

Ted continues to administer our security filings with the SEC (which grows increasingly complex), facilitate and manage trading along with our relationships with trading firms, and undertake equity research responsibilities, including evaluating large Founders commitments (you can tell that Ted does a great job managing a lot of spinning plates!).

Howard and I feel fortunate to be associated with such talented and skilled individuals while serving the best clients imaginable. Each of us at Founders Capital Management remains grateful for your business and for your faith in our stewardship. We thank you for the opportunity to serve you and for your continued trust. We look forward to working with you and continuing our shared journey in 2024.

The examples and descriptions of investments in this client letter do not represent all the investments purchased, sold, or recommended by Founders and instead represent:

- ***(1)*** ***the 10 largest equity positions held by Founders' clients;***
- ***(2)*** ***the largest equity position in each industry group to which Founders has allocated capital; and***
- ***(3)*** ***all equity positions that account for 3% or more of the total funds allocated by Founders to equity holdings.***

The performance of these investments was not a criterion in determining the representative list. It should not be assumed that the investments identified and discussed were or will be profitable.

The views expressed in this report represent the opinion and analysis of Founders Capital Management based on data available from public sources at the time of writing. This report is not intended to provide any recommendations with respect to the purchase and/or sale of any specific security. It is recommended that individuals conduct their own research or consult with an investment advisor prior to making any investment decisions.

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APPENDIX

Founders Company and Investment Culture

What Do We Focus On?

- **Act as business owners for the long haul,** as opposed to looking at investments as "paper to be flipped"
- **Act with "Rs: in mind: Reputation** (never lose it), **Responsibility (**always take it), **Reliability & Results (**focus on execution)
- **Act with character**—it's hard to describe, but we know it when we see it (when in doubt, always place others' interests before one's own)
- **Practice "mindful investing,"** fully understanding where our money is invested, as deep down as we can observe. Take complete responsibility for allocating capital, and do not abdicate money management and research to others
- **Understand the value of our held assets,** both those that are directly held and any investment with underlying assets
- **Care for clients and for each other**—collectively, we are Founders' greatest assets
- **Invest our own money as we invest for clients,** ensuring that we "eat our own cooking"
- **Maintain a human growth orientation** for individuals and clients over revenues and profits (size does not matter, but growing knowledge and embracing quality does; enrich the lives of those we interact with)
- **Seek and generate ideas, and learn from mistakes:** Mistakes are bound to happen—face them, and don't sweep them under the rug
- **Learn to learn**: Think "different" and "unmatchable," and become an organizational "learning machine"
- **Share knowledge**: Hoarding knowledge is like hoarding love—the more you keep it for yourself, the less you have
- **Think in questions vs. answers**: Insightful questions lead to greater intelligence and create options for decisions
- **Remember that the will to prepare is more important than the will to win**

How Do We View Risk?

- **Seek spread, safety, and certainty in our investments**—when practiced, speculation is eliminated
- **Always remember security:** Purchase what is dependable / defendable and predictable / protected. Analyze the potential loss before gain and focus on scenarios that can go wrong with an investment
- **Observable risks**: "See what others see"
- **Identify developing risks**: Aspire to see what others may not see, including risk creep, aggregation risk, and potential events that can cause financial fragility
- **Allow for unavoidable uncertainty**: Expect the unexpected, as the unexpected is certain to happen
- **Remember to be humble, aware, and careful—**acknowledging what we don't know is the dawning of wisdom
- **Risk sensitivity = "Margin-of-Safety"**: Be mindful of valuation and interest rates, capital structure and liquidity, franchise, business model, and management risk
- **Remember that the greatest risk is not fluctuation in the stock and bond markets—**the largest risk lies in purchasing lower-quality issues that look good today but face erosion in real value in the long run
- **Always avoid dealing with people of questionable character**: We will be associated with the company we keep. Remember that reputation and integrity are our most valuable assets—and can be lost in a heartbeat

How Do We Invest?

- **Focus on absolute over relative returns:** The investment world is full of illusory short-term comparisons that ultimately lead to permanent loss. Be risk-adverse, and abhor losing money under any circumstance
- **Seek industry and business ecosystem insight** vs. making macro predictions on the economy or market, which are certain to be wrong
- **Don't develop a master plan when investing**—be situation-dependent and opportunity-driven
- **Avoid unnecessary transactional taxes and frictional costs**—never take action for its own sake
- **Enjoy the investment process**, because studying and researching businesses is "where we live"
- **Recognize and adapt to the nature of the investment world**; don't expect it to adapt to us
- **Continually challenge and willingly amend the "best-loved investment ideas"**
- **Recognize investment reality even when we don't like it**—perhaps especially when we don't like it
- **When investing, think multidimensionally and look at investment from all angles**—this is captured by the quote "Invert, always invert"
- **Develop disciplined thinking around investment spreads**—seek to maximize cash yield spreads and practice short-term and long-term arbitrage
- **Practice 2nd- and 3rd- level thinking when investing**—always ask, "And then what happens?"
- **Develop "deep insight" and focus on value**—discern the truly valuable from the illusory
- **Remember the key elements to company evaluation:** Understand the "industry ecosystem;" describe the "investment insight"—including the company's competitive advantage, its strategic position within the industry ecosystem, and potential disruption that could erode the company's sustainability
- **Decipher the difference between certainty and uncertainty**: Understand the difference between what is knowable and important, unknowable and important, and unknowable and unimportant. Place a high value on a probable certainty of outcomes
- **NEVER SPECULATE IN ANY INSTANCE—**THIS IS A RECIPE FOR EVENTUAL FAILURE

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