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Dear Atherean Wealth Management client:

Enclosed is your portfolio summary report for the quarter ending June 30, 2023, a summary of your investment objectives and target asset allocation as per our records, and an investment advisory fee statement for the third quarter of 2023. It is important that you review your investment objectives and target asset allocation and let us know if any of it is incorrect or if there are any changes to your financial profile or liquidity needs. For a full report of the holdings in your accounts we encourage you to refer to your statements generated by the custodian.

Market and Economic Environment

U.S. real GDP grew at a 2.4% annualized rate in the second quarter of 2023, close to its long-term trend and far away from recessionary territory. Consumer spending has sustained the U.S. economy over the past few years as the excess savings cushions accumulated during the pandemic via government transfers, while depleted since their high during the pandemic, still remain historically high. While goods inflation and many components of service inflation have cooled substantially since their peak in 2021, wage and salary growth, which is much stickier and has more substantial implications for long-term inflation trends, has been in a steady uptrend since the pandemic[1]. Labor markets remain tight as the unemployment rate remains close to its 50-year low. We believe that the fed funds rate is now close to what is the long-run rate of nominal economic growth, and, while inflation and real economic growth will be more volatile over the next ten years than they were over the previous ten, long-run inflation will remain somewhat higher than the Fed's 2% target. We also believe that the long-term real economic growth trajectory in the United States will not be much different, in aggregate, over the next ten years than it was during the previous ten[2].

Equity and Fixed Income Markets – Recent Performance and Valuation

In the second quarter of 2023 global equity markets continued to move higher with the U.S. large-cap (S&P 500) index up 17%, the U.S. mid-cap (S&P 400) index up 9%, the U.S. small-cap (S&P 600) index up 6%, and the

[1] The Core PCE Deflator, Goods has fallen from a rate of almost 8 percent during 2021 to a level of about 2 recently. Meanwhile the Employment Cost Index has risen from an annualized growth rate of below 3 pct to 5 pct in the same time period. Source: MRB Partners, *U.S. Inflation: The Underlying Trend Is Still Firm*, June 8, 2023

[2] For a more detailed description of our long-term capital market expectations see, for example, MRB Partners, *Prospective Returns: Prior Tailwinds Are Now Headwinds*, May 30, 2023

Europe, Australasia, and Far East (EAFE) index up 12% year-to-date on a total-return basis as of the end of the second quarter. Bond markets have similarly rebounded from their poor performance in 2022 with the Barclays Aggregate Bond index up 2% year-to-date on a total-return basis as of the end of the second quarter. The S&P 500 is currently trading at a forward price-to-earnings multiple of 19.5[3] and the Shiller CAPE ratio is at a level of just under 31[4] as of the writing of this letter. The strong performance of the market-cap weighted S&P 500 in the first half of 2023 has been driven primarily by the technology and communication services sectors[5], the result of what we believe could be an emerging bubble related to technology and artificial intelligence ("AI").

Portfolio Management and Investment Philosophy

In *The Affluent Society*, economist John Galbraith decribes the modern economy as a place where "the productive process incorporates the means by which wants are created, and these are further sustained by fashion, social aspiration and simple imitation…first you make the good, then you make the market"[6]. Because there is a tendency to do what others do and think what others think, there emerges a network effect of group-think as relates to not only the consumer but to the investor as well. Accordingly, when a new technology emerges, it tends to become popular with large numbers of investors and attract substantial amounts of capital. This has the effect of reducing the cost of capital for the industry as a whole which, in turn reduces the required return of investments in the industry. Such was the case with the automotive and airline industries in the early part of the twentieth century (when most of the capital invested into these industries was destroyed) and the internet, technology and telecom bubble of the late 1990s (when, similarly, most of the capital invested into these industries went up in smoke). In our current era where much focus is on companies and industries which are interesting, "disruptive" and new, such as artificial intelligence ("AI"), we, as value investors, are turning toward industries which have stood the test of time, are long-term durable, and which provide goods and services which society needs rather than simply wants (or thinks it wants). Most industries and companies will undoubtedly benefit from the cost savings and increased efficiencies which AI brings to the economy as a whole even though these companies are not creating or developing AI per se. Because such products and services are more mundane and less interesting, the cost of capital, and hence required return, is higher. Accordingly we believe that companies in such industries can frequently be purchased at a substantial discount to their intrinsic value. With this we turn to the U.S.-Canada trade relationship, which involves transporting many necessary and essential goods such as coal, chemicals, grains and fertilizer over rail networks.

The U.S.-Canada trade relationship is the largest in the world, with two-way trade in goods and services totaling US$762.8 billion in 2021[7]. Top Canadian exports include crude petroleum, cars, petroleum gas, gold, and lumber, while top imports include cars, automotive parts and accessories, delivery trucks, refined petroleum, and crude petroleum. While crude oil and gas are for the most part moved between the two countries through transmission pipelines, the bulk shipping of chemicals and commodities such as grain, fertilizer, forest products, metals, minerals and metallurgical coal typically occurs over rail due to its low cost and logistical convenience. As commodity and fuel prices increase, sourcing bulk raw materials close to their usage point or next point in the supply chain and/or minimizing shipping costs will be important. Shipping by air and truck is becoming more expensive due to rising wages and rising fuel costs[8], which provides a tailwind for intermodal shipping

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[3] Source: Yardeni Research, Inc, "Stock Market Briefing: Selected P/E Ratios", July 21, 2023

[4] For July 2023. Source: Robert Shiller via YCharts

[5] MRB Partners, *Identifying Opportunities Among Major Non-U.S. Markets*, July 25, 2023

[6] John Galbraith, *The Affluent Society*, 1998 Edition, Original Edition 1958

[7] This is larger than Canada's two-way trade with China, Japan, Mexico, Germany and the U.K. combined

[8] An example is the recent UPS strike settlement where wages for UPS workers were substantially increased. UPS accounts for over 50% of market share of the transportation and logistics industry in the United States

involving rail. Freight railroads have been transporting goods throughout North America for almost 200 years[9], surviving numerous periods of bankruptcies and consolidations. They remain the least expensive way to ship goods over land, with estimates ranging between 1/3rd the cost to 1/10th the cost of shipping by truck. Additionally, external costs, such as wear and tear on infrastructure, traffic congestion, traffic fatalities, and carbon emissions per ton-mile of goods moved are substantially lower for rail than they are for trucks. North American railroads are essentially monopolies which own their tracks (in contrast with European railroads where the government owns the tracks), with 5 class I freight railroads operating in North America which run 67 percent of freight mileage and earn 94 percent of the freight rail revenue[10]. Over the past 20 or so years, North American railroads have undergone an operational transformation from their old logistical model to a precision scheduled system. Precision Scheduled Railroading ("PSR"), first implemented at Illinois Central Railroad in 1993 by pioneer E. Hunter Harrison, involves running a freight railroad on a fixed schedule, similar to a passenger railroad or airline. In the traditional system which existed prior, trains would wait until they were full before departing, which would result in customers getting their cargo late and cars sitting idle at terminals and logistics hubs for extended periods of time. In contrast to the traditional model, where the focus was on moving entire trains, a precision scheduled system focuses on moving cars and maximizing the average car velocity across the rail network. This has had the effect of reducing the amount of time that cars are sitting unused at terminals and logistics hubs, increasing the rail network efficiency, lowering costs, and improving reliability.

In summary, due to their operational efficiency, high margins, high pricing power, growing customer base, and reasonable valuations, we consider the North American freight railroads to be attractive and in the second quarter we took a long position in Canadian National Railway (NYSE:CNI)[11]. With almost 20,000 miles of track the CNI railroad network runs coast to coast in Canada from Vancouver and Prince Rupert to Halifax and down through the United States to New Orleans and Mobile, feeding intermodal logistics hubs along the Missisippi River. Profit margins exceeded 30 percent in 2022, up from about 15 percent 20 years ago largely as a result of operational efficiencies obtained from the conversion to a precision scheduled system in the early 2000s. We believe that the pricing power of railroads is alive and well due to their substantial price advantage over other modes of shipping and their monopolistic characteristics. At a P/E multiple of under 20 we believe that CNI is attractively priced and that, through a combination of share-count reduction due to stock buybacks, growth in shipping volumes, the ability to gradually raise shipping prices and the growth of the U.S.-Canadian trade relationship the company will be able to grow its free cash flow per share at a reasonable rate over a long time period.

As always, we are available to discuss your investment portfolio, discuss your financial plan, or address any other questions or concerns which you may have. Please feel free to reach out via phone or email if you would like to speak with us.

Sincerely,

Atherean Wealth Management, LLC

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[9] The Baltimore and Ohio Railroad is the oldest freight railroad in the United States and its 14 miles of track were constructed in 1830-1831. Source: The Library of Congress, Railroad Maps, *The Beginnings of American Railroads and Mapping*

[10] Source: Rail Inc: *An Introduction to Class I Freight Railroads*

[11] The securities which we discuss in this letter are not necessarily allocated to all of our client accounts. Whether or not we choose to allocate a particular security to your account will depend on your risk tolerance, investment objectives, tax situation and objectives, and liquidity needs. Nothing printed in this letter should be construed as a solicitation or an attempt to effect transactions in securities.