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October 31, 2023

Dear Atherean Wealth Management client:

Enclosed is your portfolio summary report for the quarter ending September 30, 2023, a summary of your investment objectives and target asset allocation as per our records, and an investment advisory fee statement for the fourth 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

By many measures the U.S. economy is running strong with real GDP clocking in at a 5.4% annualized rate in the third quarter of 2023, unemployment remaining close to an all-time low, and corporate credit spreads remaining tight. The treasury yield curve steepened[1] in the third quarter and ten-year treasury yields have been rising steadily since April, recently exceeding 5%. This is their highest level since 2007 and is in excess of the S&P 500 earnings yield, a situation which has not occurred in an environment of economic growth since the late 1990s[2]. Despite the majority of economic indicators signalling a robust environment, smaller cap issues sold off more than large cap issues in the third quarter and the S&P 600 small cap index currently trades at a forward P/E ratio of just over eleven, close to its lowest level since the recessionary aftermath of the global financial crisis[3].

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[1] This has been corrected from the original letter we sent clients on October 31, 2023, where we used the term “flattened” instead of “steepened”. The yield curve went from inverted to less inverted, i.e. the long end increased more than the short end.

[2] As of October 26, 2023 the trailing earnings yield of the S&P 500 was about 4.3% (source: Yardeni Research, Inc: “S&P 500 Trailing P/E Ratios”, October 26, 2023), which was less than the 10-year treasury yield of 4.9%. Put another way, the equity risk premium is currently negative. While this situation has not occurred during a period of economic growth since the internet bubble, we also need to keep in mind that nominal S&P 500 earnings get a boost in growth rate from the inflationary environment which we are currently in, and accordingly may indeed deserve a higher multiple/lower earnings yield than they would in a less inflationary environment. It is also important to keep in mind the degree to which the mega-cap stocks of the S&P 500 distort the valuation metrics of the cap-weighted index due to their current level of high concentration. Nevertheless it is a strange environment we are in when you can earn a higher yield in treasuries, for taking zero risk, than you can in the S&P 500 index.

[3] Source: Yardeni Research, Inc: “Stock Market Briefing: Selected P/E Ratios”, October 26, 2023. The S&P 600 forward P/E ratio hit a low in late 2008 of about 10, which was after the recession was officially announced, and its lowest level since at least 1999.

Equity and Fixed Income Markets – Recent Performance and Valuation

Year-to-date as of the end of the third quarter the U.S. large-cap (S&P 500) index was up 13%, the U.S. mid-cap (S&P 400) index was up 4%, the U.S. small-cap (S&P 600) index was up 1%, and the Europe, Australasia, and Far East (EAFE) index was up 8%. On a total return basis bond markets, while performing better than they did in 2022 when they were down 13%, are down again in 2023 with the Barclays Aggregate Bond index down 1% year-to-date on a total-return basis as of the end of the third quarter. The S&P 500 is currently trading at a forward price-to-earnings multiple of just over 17[4] and the Shiller CAPE ratio is at a level of just under 31[5] as of the writing of this letter.

Portfolio Management and Investment Philosophy

We continue to invest in long-term compounders, i.e. companies with steady cash flows, wide economic moats, strong balance sheets and a long and consistent history of effectively reinvesting their cash flows. In the third quarter we took a position in engine and power provider Cummins[6] (NYSE: CMI). The company was founded in 1919 as one of the pioneer diesel engine manufacturers in the U.S., and in 1928 the company produced the Model U engine, which powered one of the first diesel-powered highway trucks. This effectively marked the beginning of the highway trucking industry as we know it today, and as of now the company holds about a third of the market share for diesel engines used in highway trucks. Since its inception the company has significantly increased its product portfolio and today the company produces, distributes and services a wide variety of internal combustion, electric and hybrid power solutions whose applications include medium- and heavy-duty trucks, buses, oil and gas equipment, rail, agriculture, defense, power generation, mining, marine, and fire and emergency. Over the past ten years the company has returned almost two thirds of its operating cash flow to shareholders in the form of dividends and share buybacks, and has been steadily increasing its dividend since the late 1990s. The company has maintained a solid, conservative balance sheet throughout its recent history with long-term debt currently at about 25% of assets and 100% of EBITDA and an interest coverage ratio of just over 18. As the stock is priced at just under eleven times forward earnings for an earnings yield of almost 10%, we consider it attractive given that the company has grown its earnings per share at an almost 9% annualized rate over the past ten years.

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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[4] Source: Yardeni Research, Inc, "Stock Market Briefing: Selected P/E Ratios", October 26, 2023

[5] For September 2023. Source: Robert Shiller via YCharts

[6] 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.