Kevin R. O'Brien
Portfolio Manager

Jason A. Kish
Portfolio Manager

Steven R. Labbe
Portfolio Manager

Q4
2023

ISSUED FEBRUARY 6, 2024

Prospector Partners Quarterly Commentary

"A great business at a fair price is superior to a fair business at a great price."
Charlie Munger

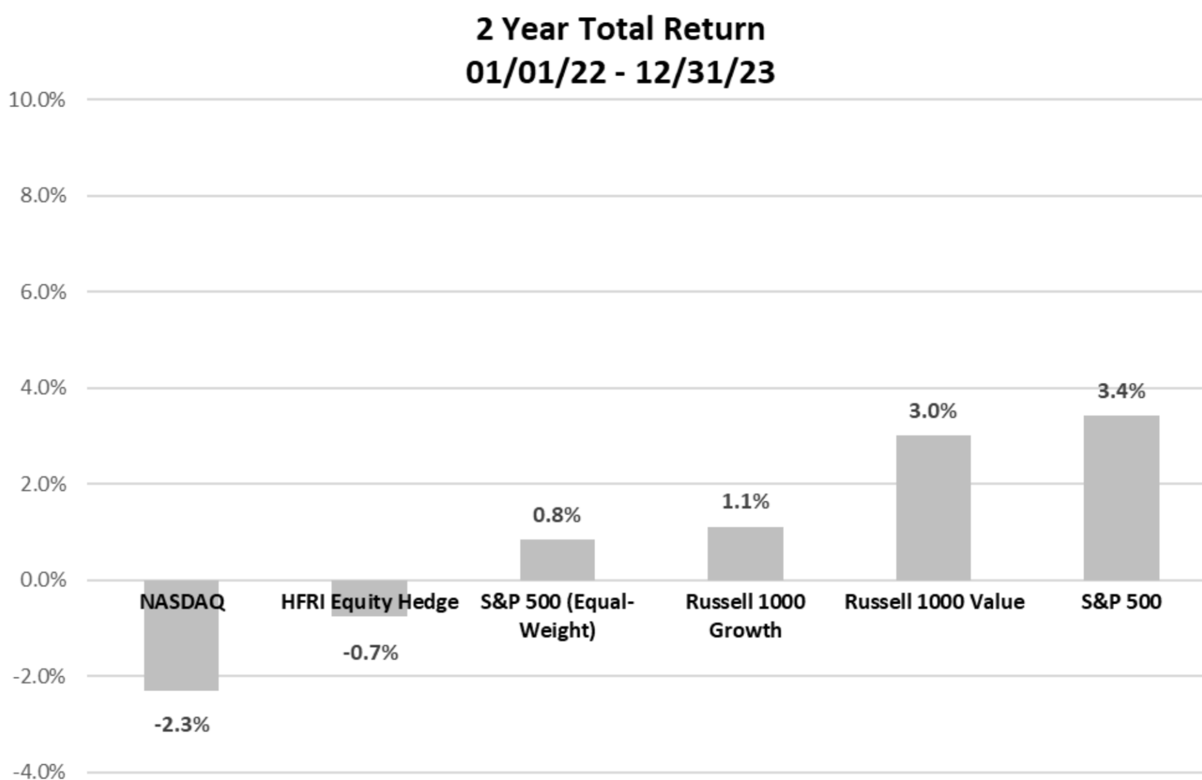
We would be remiss to not acknowledge the passing of legendary value investor, and long-time Warren Buffett partner, Charlie Munger. As has been written about many times over, Buffett credited Munger for transforming his approach to value investing – rather than looking for dirt cheap "cigar-butts," Munger was a strong proponent of buying very good businesses at fair prices. At Prospector, we consider ourselves among the many value investors who have utilized a variation of this approach for decades. We owe a debt of gratitude to Charlie, and his contributions to the world of investing.

Current Market Environment

We entered 2023 in the midst of very restrictive monetary policy, a deeply inverted yield curve, significantly higher interest rates and the continued drying up of consumers' post-pandemic excess savings. A Wall Street Journal survey of economists pegged the chances of a recession at 63% heading into the year. This foreboding backdrop was followed in March by the largest bank failures on record... Not the greatest setup for a bull market.

What would follow is one of the more bifurcated markets in memory – with technology stocks dominating virtually everything else. More specifically, a handful of mega-cap tech stocks, now known as the "Magnificent 7" captured headlines (and asset flows) much of the year, stemming from excitement over the prospects for artificial intelligence. These names, (which include: Microsoft, Amazon.com, Meta Platforms, Apple, Alphabet, Nvidia, and Tesla) gained an average of 105% for the year, with Apple being the laggard – up 49%. They alone contributed over 16 percentage points of the S&P 500's 26.3% return for the year. Notably, the strength and size of these stocks masked investor unease elsewhere regarding the prospects for inflation and the economy. Indeed, the equal-weighted S&P 500 had produced a negative return through the end of October as 10-year Treasury yields peaked over 5%, fueling fears of a Fed-induced recession.

However, sentiment sharply reversed in November, when the Consumer Price Index (CPI) came in below expectations, seemingly putting an elusive "soft landing" for the U.S. economy into view. This kicked off a stock market rally, which only picked up steam in December, following what most thought was a dovish Federal Reserve meeting. Bonds rallied on expectations of an end to the Fed's hiking cycle, and the decline in interest rates helped fuel what some have called a "dash for trash" rally, where the most levered and speculative stocks led the market. Despite the dramatic uplift in November and December, and the remarkable tech-stock rally during the year (which saw the NASDAQ return 45%, and Russell 1000 Growth Index gain 43%, outpacing its Value counterpart by over 31%), one could be forgiven had they awakened from a Rip Van Winkle-like two-year slumber, only to think not much had happened during their sleep. After all, while 2022 and 2023 both felt like wild rides at times, and had their share of volatility, cumulative returns for the aforementioned indices have been fairly unremarkable over the period (as seen in the chart below).



Financial Services Update

The reemergence of inflation in recent years has had a significant impact on the insurance industry. Claims inflation from natural catastrophes, labor, repair costs and supplies, as well as legal settlements, has created a need for property-casualty (P-C) insurers to both increase their carried reserves for previously accrued claims as well as increase expected expenses for claims yet to occur. The companies have been raising prices now for years to get ahead of this significant change in loss trend. We have meaningful investments in companies who, in our view, have the ability to reserve accordingly and price at necessary levels to improve margins and returns. Insurance brokers (middle-men) have also benefited meaningfully from these price increases, as their commissions and fees have accelerated somewhat consistently with the higher premiums paid by their customers.

This new era of higher absolute interest rates has also had a meaningful impact on property-casualty investment portfolios. Insurers' portfolios do not turnover 100% every year, but in general, property-casualty insurers' portfolio durations tend to be about 3-4, and the benefit of investing today's collected premiums at yields well in excess of existing portfolio yields will accrue for years to come. Insurance brokers have also benefited from the higher short-term yields attained on the "float" they manage (premiums collected from customers and remitted to insurance carriers).

Life insurance companies' investment portfolios turn over even less rapidly than property-casualty insurers', but the benefit does accrue to their financials as well (over a longer period of time). However, we have meaningful investments in companies whose cash generation and portfolio turnover compares favorably to others in the sector. Additionally, these companies have benefited from a meaningful normalization of mortality post the worst days of the pandemic.

Shares of P-C and Life insurers have performed commensurate with the aforementioned tailwinds. However, we are constantly reassessing the attractiveness of these investments versus other opportunities we find, and we have reduced our exposure in certain areas of insurance where pricing is no longer in excess of loss inflation and/or where valuations no longer appear to have room to expand. As always, we diligently strive to more heavily weight portfolios in the opportunities where we see the greatest asymmetry of returns and it is through this lens that reductions in insurance will be made.

At this point, banks have realized the majority of expected net interest margin compression. While this substantial overhang has been absorbed, there are other potential headwinds which keep us from getting significantly more bullish. The late 2023 bank rally was predicated on market optimism for a soft landing and rate cuts. This is well reflected in Street estimates for credit losses which are optimistic in nature as loss reserves remain materially below historical averages. A slowdown in the economy could result in a 15% to 25%+ reduction in forward EPS from higher loss provisioning. Other headwinds include: a modest loan growth outlook, rising capital levels, increasing regulatory costs, limited capital return, a weak M&A backdrop, non-bank market share gains and continued cost headwinds from inflation. We maintain a robust watchlist of potential ideas and patiently await a better entry point on fundamentals and valuations before we decide to more meaningfully increase exposure.

Outlook

Since early 2022, the Federal Reserve has aggressively raised interest rates in an effort to lower inflation, causing significant uncertainty within stock and bond markets. While the rate of inflation has subsided, and the consensus appears to be we have reached an end to the Fed hiking cycle, declaring victory would be premature. The U.S. and rest of the world continue to manage the impacts of inflation, higher interest rates, and geopolitical events. In our assessment, there remains a possibility of Federal Reserve policy error and / or recession, though barring extraneous events, we still lean towards slowdown and not recession per se.

The biggest risk right now would seem to be from a "shock to the system" during this period of relative weakness while we are transitioning from the pandemic economy to a more normalized economy. Certainly, the traumatic events in Israel, and the risk of potential systemic shock that might spread from the Middle East in the months to come, keep us up at night as we are sure they do you as well. As always, with our bias towards quality, we strive to mitigate any downside, while also participating in the upside.

Meanwhile, employment remains strong. Heavy fiscal stimulus from already passed U.S. legislation for defense, infrastructure, semiconductors, and energy investment are only now beginning to be awarded. The spending will not peak until later in the decade. Relatively high energy costs in Europe, and Germany in particular, makes manufacturing here relatively more attractive. Political risk in China makes that country less attractive to do business in. All told, U.S. manufacturing is being called upon to step up. Barring a major crisis, Ronald Reagan's termed "willing workers" should be able to find jobs…and pay their bills. Furthermore, supply / demand imbalances in the labor market suggest further wage gains to come which will partially mitigate the impact of inflation on the consumer. We expect continued pressure on housing prices as a result of higher interest rates and affordability concerns. However, the shortage of housing after over a decade of underinvestment following the Great Financial Crisis should prevent a disastrous decline in home prices. Lower-income consumers have been most impacted by the current inflationary environment, but consumer balance sheets remain generally healthy for the majority of Americans, and consumer credit quality remains strong at the moment.

While what we see argues for a more inflationary and higher interest rate environment than seen in the past ten years, it also does not argue for a recession. Nonetheless, the unexpected can occur. Should a recession happen in the near term, the factors highlighted above suggest it could be less significant than the previous two recessionary periods. We are also mindful that 2024 is an election year, the result of which could have implications on companies, sectors and the overall economy.

Following years of lower interest rates helping to drive ever-higher growth-stock valuations, we feel value investing is ripe for a period of outperformance. We continue to find opportunities to invest in quality businesses with solid balance sheets and cash flows, whose share prices have detached from our assessment of the fundamentals.

WWW.PROSPECTORPARTNERS.COM

370 Church Street, Guilford, CT 06438
203.458.1500

The views described herein do not constitute investment advice, are not a guarantee of future performance, and are not intended as an offer or solicitation with respect to the purchase or sale of any security. Investing involves risk, including loss of principal. Investors should consider the investment objective, risks, charges and expenses of a Fund carefully before investing. Please review the offering memorandum or prospectus of a Fund for a complete discussion of the Fund's risks which include, but are not limited to: possible loss of principal amount invested; stock market risk; value risk; interest rate risk; income risk; credit risk; foreign securities risk; currency risk and derivatives risk.

Nothing contained herein constitutes investment, legal, tax, or other advice nor should be relied upon in making an investment or other decision. Any projections, outlooks or estimates contained herein are forward looking statements based upon specific assumptions and should not be construed as indicative of any actual events that have occurred or may occur.