



Managers' Letter 4th Quarter 2023

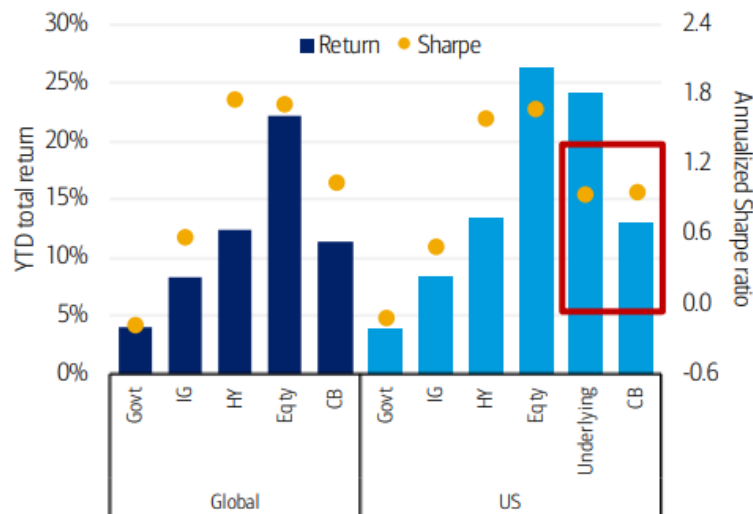
Jacques Berghmans and Félix Berghmans

Economic and Market Environment

Twelve months ago, most investors were shell-shocked by the return of double-digit inflation in the Western World, a bear market in supposedly 'safe' corporate & government bonds, war in Europe, an energy crisis and pretty poor stock market returns in most of the world. At TreeTop, having gone through a number of crises over the years, we reminded ourselves that global equity markets, while very reactive in the short term, provide excellent inflation adjusted returns over the long term. We are happy to say that 2023 confirmed our beliefs with global equity markets outperforming most asset classes (government bonds, high yield & investment grade credit) driven by the outstanding performance of the American stock market.

Exhibit 12: Cross-asset performance and Sharpe ratios

Though they underperformed broad market stocks and HY bonds, CBs led IG and government bonds on both an absolute and risk-adjusted basis in 2023



Source: BofA Global Research, ICE Data Indices, LLC. Data as of 31-Dec-2023.

BofA GLOBAL RESEARCH

While 2022 was mostly marked by the terrible invasion of Ukraine by Russia and its important economic and financial consequences, 2023 was much more positive with a reduction in inflation, a stabilization of global interest rates and a progressive resolution of the energy crisis in Europe. One of the big economic issues in 2022 was the explosion in energy prices in Europe, as shown on the next graph below, which led to a rapid increase in the cost of living. Fortunately, natural gas prices in Europe started to come down at the end of 2022 and have been relatively stable ever since. This came as a result of significant efforts by European households, corporates and governments to reduce demand and find alternative sources of energy. Given the structural improvements in the European energy markets, there is hope that the situation will be stable going forward.



Figure 1 - Natural Gas Prices in Europe (green), United States (black), China (orange)- Source: Bloomberg

With fast increasing energy costs, came the highest inflation since the birth of the euro. For the first time, eurozone inflation went above 10% (in green on the graph below), in September 2022. In the US, a similar wave of high inflation (in black below) was partially due to higher energy costs, but unlike in Europe, was mostly the consequence of very aggressive monetary and fiscal policies post the COVID-19 pandemic, as well as supply chain bottlenecks. In contrast to Western economies, the Chinese economy saw very muted price increases and is now experiencing deflation with its CPI (Consumer Price Index) turning negative in recent months (in orange below).



Figure 2 - Inflation (CPI) in Europe (green), the US (black) and China (orange)- Source: Bloomberg

The fast increase in inflation also saw the end of 'free money' in Western economies with the Federal Reserve ('FED') and the European Central Bank ('ECB') rapidly increasing their benchmark interest rates. Short-term US interest rates (in orange below) rapidly increased as a consequence, followed by long term US (in blue) and European (in green) rates before stabilizing in recent months.



Figure 3 - US short term (orange) and long term (blue) interest rates VS German 10 years government bond yield (green)- Source: Bloomberg

The end of ‘free money’ had a dramatic impact on financial assets, especially fixed income (debt & bonds) and now real estate. In this gloomy environment, a positive surprise was the **resiliency of global earnings**. While the global stock market (in white below) went down roughly 25% between its peak at the beginning of 2022 and the bottom 6 months later, global earnings (in yellow below) continued to increase in 2022 and have been stable over the last 18 months. The earnings resiliency combined with stable interest rates drove the significant market comeback in 2023.



Figure 4 – Global stock markets (white) vs Global earnings (yellow) - Source: Bloomberg

The US market comeback was even stronger than the global stock market with the S&P500 now close to its all-time-high (white line below). Like for the global stock market, the recovery was mostly driven by earnings (S&P500 EPS in yellow below) and is based on fundamentals. A very interesting characteristic of the US equity market for investors is its ability to regularly double earnings per share. Over the last twenty-five years, the S&P500 doubled its EPS twice - between 1997 and 2006 and between 2006 and 2020. While the dot-com bubble in 2000, the global financial crisis in 2008 and the pandemic in 2020 created significant earnings draw-downs and market volatility, they didn’t structurally disrupt that ability to grow EPS (Earnings Per Share).

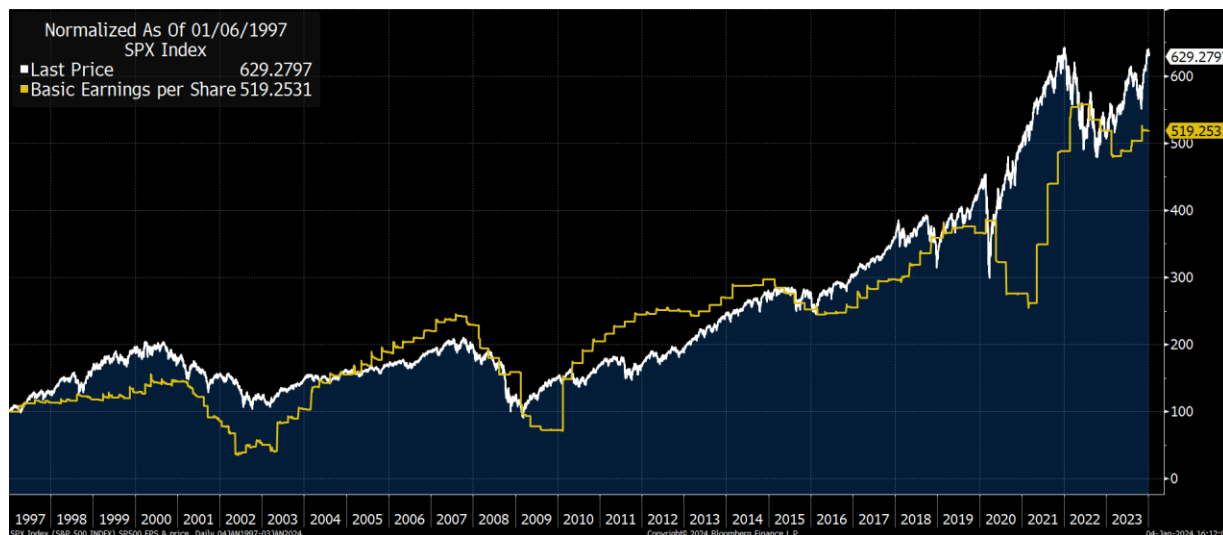
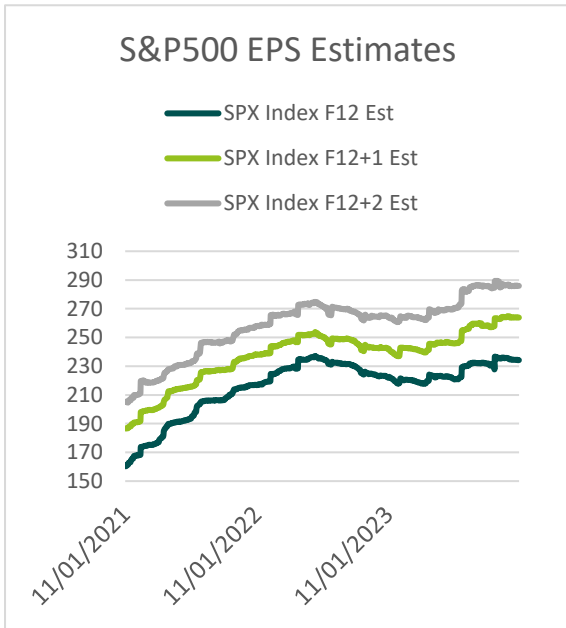
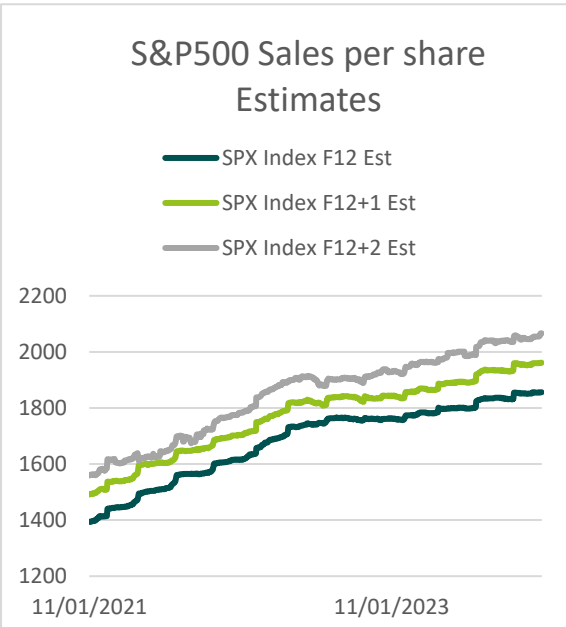


Figure 5 – S&P500 (white) vs S&P500 Earnings per share (yellow) - Source: Bloomberg



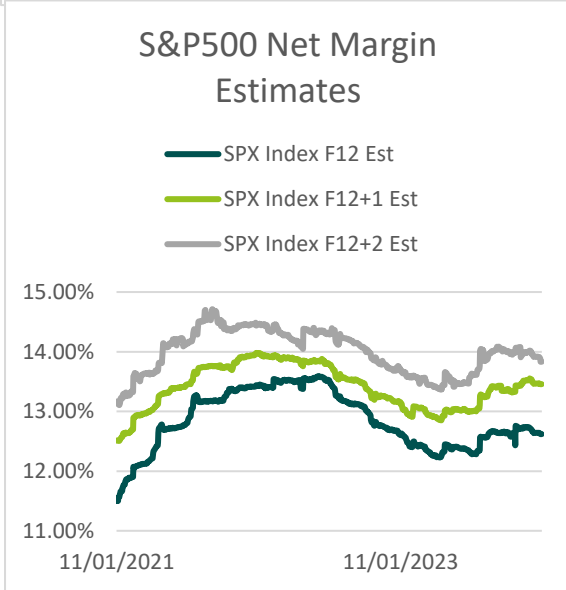
As financial advisors like to repeat, the past is not necessarily a good representation of the future, and while earnings growth has been good in recent years, it does not mean that it will be good in the next few years. Fortunately for equity investors, there has been a recent acceleration in earnings growth expectations for the S&P500, the major driver of global equity returns. The graph on the left tracks analysts’ consensus forecasts over time for the next three years. In dark green, we see what analysts expect for 2024, in light green for 2025 and in grey for 2026. More than the absolute number, the evolution of the estimates is what matters the most. A rapid increase in consensus estimates tends to go with positive market performance, while a stagnation or a drop of estimates will generally be negative for markets. 2022 saw a stagnation and we had negative market performance, while 2023 and especially 2021 saw a rapid increase in estimates leading to much more positive market returns.



Two interesting drivers to look at to better understand EPS are sales per share (graph in the middle) and net margins (final graph below).

$$EPS = Sales\ per\ share \times net\ margin$$

From these graphs, we can see that the earnings stagnation observed from late 2022 came mostly from pressure on margins and to a lesser extent from slower revenue growth. Analysts’ net margin estimates for the S&P500 dropped from 13.5% in June 2022 to 12.2% before stabilizing and slowly climbing back (dark green line on the last graph below). This pressure on margins was concurrent with the acceleration in inflation and the prick-up in interest rates. Since the macro-economic situation has stabilized, margin expectations started to progressively increase but remain below their peak of 2021.



We don’t have a crystal ball and events like the Ukraine invasion, or a global pandemic are unpredictable by nature. Nevertheless, management teams of listed companies - especially American listed companies - will always fight to grow their company’s profits over the medium to long term¹. Unlike fixed interest rates on bonds, earnings will also naturally grow with inflation. For the patient investor, this should result in good returns¹.

At TreeTop, we have been believers of global equity for a few decades now. In the short term, there will always be significant volatility, as everyone tries to second-guess what will happen in the next twelve months. Over the longer term though, returns start to smooth out and we hope that 2024 will be as good a vintage as 2023 has been.

Figures 6,7 and 8 – S&P500 estimates - Source: Bloomberg

¹ No guarantee of results or performance

Our convictions

Our first conviction at TreeTop is to look **globally** for the best possible investment opportunities. Among my first investments were Japanese bonds in the seventies, followed by a golden period for Japanese convertible bonds in the eighties. During my twenty years at Merrill Lynch, I invested for clients and myself in American hedge funds, American technology stocks, Korean conglomerates and emerging markets. Looking back at these forty years of investments, I can say that my second conviction is the **need to be flexible and quickly adjust yourself to new situations**. In the first decade of my career, Japanese assets were all the rage then were dreadful. This was followed by the American Internet boom and then a bust. The 2000's was the decade of emerging markets followed by a second technology boom in the United States.

The way people invested also changed drastically. When I started in this industry, I wrote to a few dozen companies to receive their annual reports and corporate communication. I quickly filled a room at my parent's house and had to write back to all the companies to stop sending me literal 'truckloads' of paper. Back then, information was limited while today we suffer from an overload of data. Diversification in the eighties consisted of having a few stocks outside the Bel-20, while today everyone can buy the whole global stock market through a tracker in a few clicks. At TreeTop, we have always tried to evolve with time and will continue to do so. We started with a few **high conviction active management funds**, then followed with a **passive global equity fund** and then launched **quantitative strategies** two years ago. In my last newsletter, I explained this evolution in more detail and the pros and cons of every strategy. Now it is time to look at how these strategies performed in 2023. The first piece of good news is that unlike in 2022, where we only had one or two products with positive performance, all our strategies delivered positive performance in 2023.

Our passive strategies with a notably ESG angle outperformed global indexes as they have significant exposure to the American technology sector. Our other strategies, while they all performed well, tended to underweight the so-called 'Magnificent Seven', the seven large American mega-capitalisations (Amazon, Apple, Alphabet, Microsoft, Meta, NVIDIA & Tesla) and tended to deliver performance a bit lower than the global equity indexes. In recent years and especially in 2023, global equity market performance has become somewhat shallower, with fewer and fewer stocks, mostly American ones driving global returns. 2022 was the first accident in this evolution. Raising interest rates decimated the Nasdaq that year and some mega capitalisation stocks fell over 50%. Feeling somewhat uncomfortable with the high valuation of the American technology sector and 'growth investments' in general, we launched a few quantitative value strategies in 2021 which helped us very much in the following twelve months. At the dawn of 2024, it looks like some large companies are very expensive again, and we would tread carefully. To counterbalance the American technology behemoth, our **active strategies** are focused on emerging markets, convertible bonds, European entrepreneurial mid-size capitalisations and global high growth mid-capitalisations. Our **quantitative systemic strategy** is focused on members of the S&P500 with high free cash flow yield, meaning they are cheap and with significant share buyback programs, which means the management teams believe their stocks are cheap.

Our quantitative strategy has now fully moved to the **S&P500 US Buyback Free Cash Flow Index**. Performance has been good though not outstanding. It has owned over 60 names since the start of the strategy, with the top three performance contributors being **INTEL**, the US chipmaker, **BROADCOM**, a leading US telecommunication equipment provider and **EXPEDIA**, an Internet tourism portal. The strategy doesn't shun American technology names, but it only buys them when there is valuation discrepancy. The strategy even owned **META (ex-Facebook)** this year, as it was very cheap at the end of 2022 and presented very good relative value. Management teams are not always right when buying back their shares, **PFIZER**, the leading US pharmaceutical company unfortunately continued to drift and detracted our overall performance as well as **WALGREENS BOOTS ALLIANCE**, a large pharmaceutical retailer in the US.

In general, though, we are pleased about how this strategy quickly adjusts positions to find relative value. It also focuses on very large companies, meaning it should avoid grave accidents. Finally, we are more and more convinced that management teams, in an increasingly complex world, should focus on what they know best. We much prefer to have companies distributing capital to shareholders, who can then allocate to the best opportunities, than companies who diversify or over-invest in their business.

We wish you all the best for 2024 and our TreeTop team remains available for any eventual questions.

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Data & Information as of 29th December 2023

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