



Managers' Letter 1st Quarter 2024

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Economic and Market Environment

As we write this newsletter, a number of economists & financial commentators are closely watching the release of inflation data in the United States. At TreeTop, we are not too concerned about short term economic data, though this release reminds us of the importance of inflation for the long-term investor. Fortunately, inflation in the United States (the black line on the graph below) and Europe (green line below) has fallen significantly over the last twelve months. This is very good news, as the level of inflation we saw in 2022 often leads to wage-price spirals, where increasing prices lead to higher wage demand and further price hikes. Fortunately, this time, a combination of very aggressive rate rises by the European and the American central banks, and lower energy prices in Europe broke the back of inflation before it got out of control.

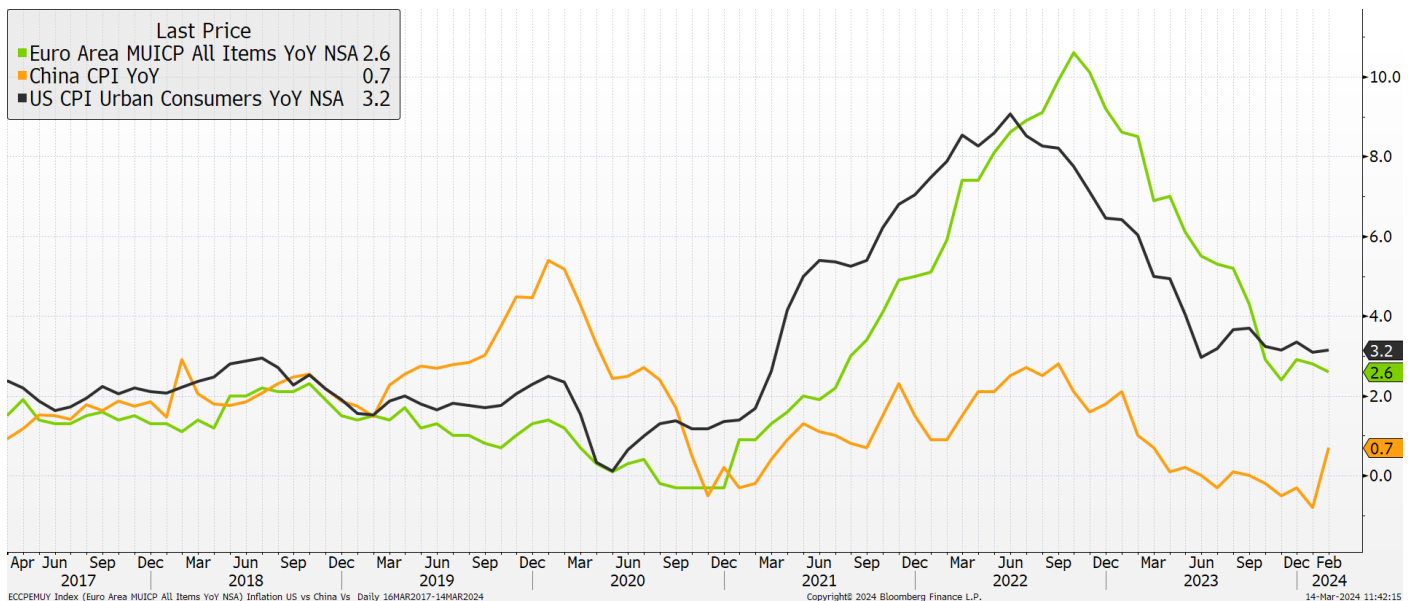
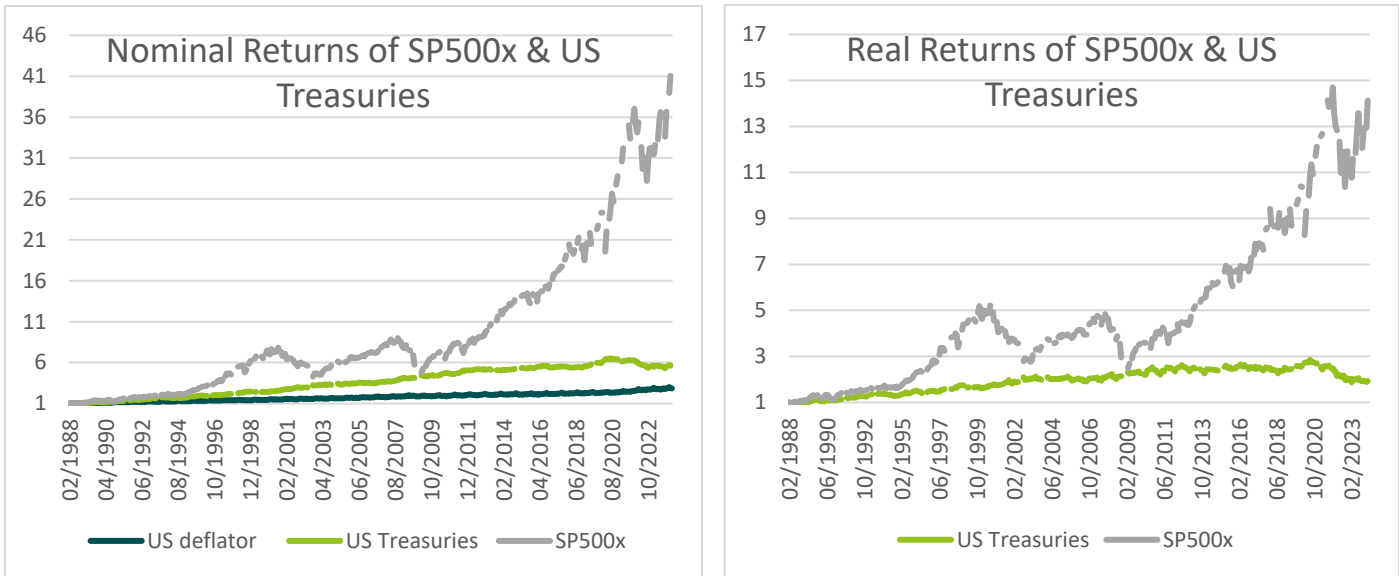


Figure 1 – Inflation (CPI) in Europe (green), the US (black) and China (orange) - Source: Bloomberg

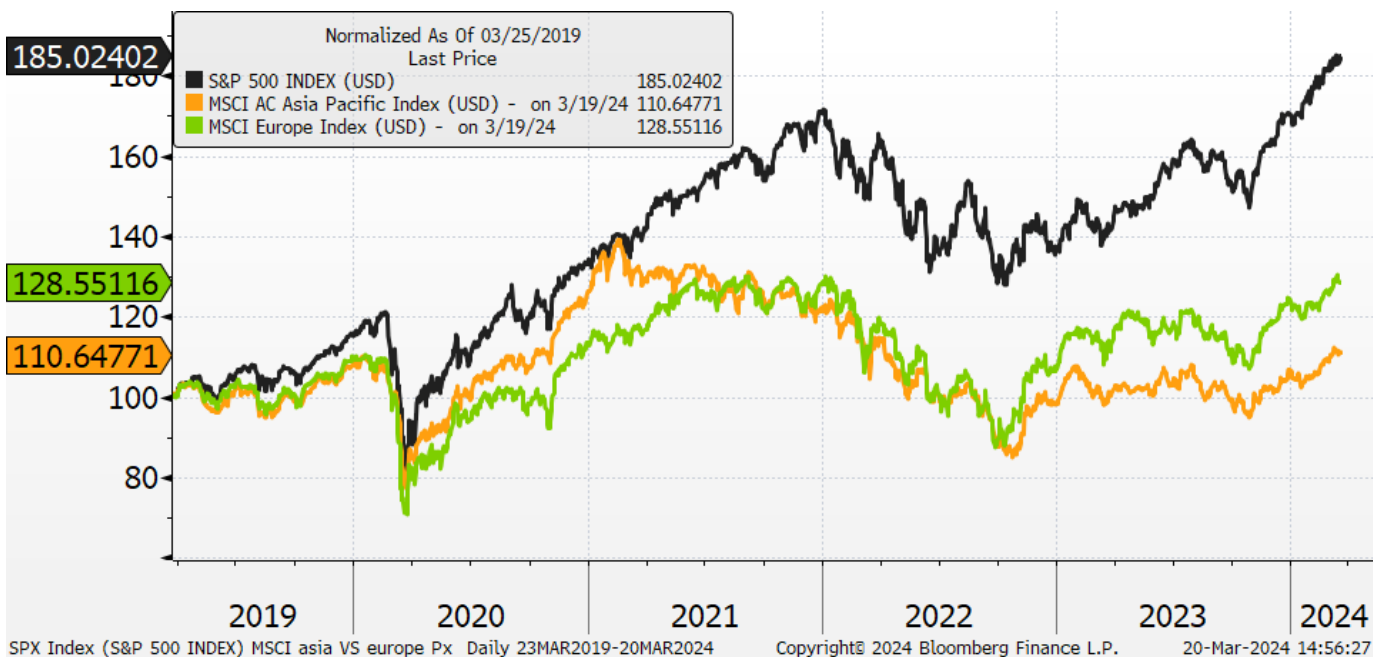
Inflation is a very important factor to consider for long term investors. Over short periods, losing 2 to 3% of purchasing power per year might not seem very much, but the impact will be significant over longer time periods. One of the most important goals of investment is 'to protect' the purchasing power of hard-won savings. One US dollar from 1988 is now 'only worth' 35 cents meaning that it has less than 50% of its initial purchasing power. This loss of value happened in a country, and during a period, where inflation was well under control; a 1988 Brazilian real for example has almost no real value today. On the graphs below, we can see the huge difference inflation makes over the long term. Nominally, an investor in the US stock market would have made 40x his/her initial investment (S&P500 total return) and more than 5x his/her investment in US treasuries (US Treasury Index, LUATTRUU Index) since 1988. After inflation though, the picture is less rosy with the US stock market delivering a 14x real return and US treasuries a 2x real return.

Over a shorter period of high inflation, the impact can be even stronger. In real terms, the US stock market is still below its peak in 2021 and investors have not made any money in treasuries after inflation since 2003!



Figures 2 and 3 – Nominal returns and real returns of S&P500 and US treasuries since 1988 - Source: Bloomberg

The emergence of inflation also has an impact on global interest rates and the valuation of financial assets. The primary function of modern central banks in America, Europe or Asia is to keep a tight lid on price increases and their primary tool is to set the level of short-term interest rates. The last three years is a text-book example of what happens when central banks are confronted with a sudden surge in inflation and the consequences on financial markets. As inflation surged in 2022, global central banks aggressively raised their rates, affecting a broad range of assets including equities, bonds and real estate. In 2023, inflation and rates stabilized and the global stock market rebounded strongly, while most other assets just stopped falling (please refer to our previous newsletter). In the first three months of 2024, a stable global economy with reasonable inflation as well as a booming US technology sector, driven by artificial intelligence, led to strong equity performance driven by the US market (black line below)¹.

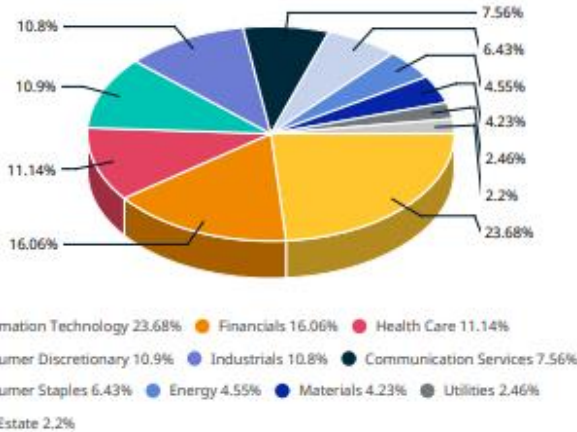


¹ Past performance is no guarantee of future performance.

Figure 4 – Equity markets evolution in the US (black), Asia (orange) and Europe (green) - Source: Bloomberg

After years of outperformance, the US market now makes up the majority of the global stock market. As of March 2024, the MSCI All Countries World Index (ACWI), the most popular global equity tracker representing “85% of the global equity opportunity and USD70 trillion of market capitalisation” according to its provider MSCI, has a weighting of nearly 64% in American companies. The next biggest constituent, Japan, only accounts for slightly more than 5% of the market.

SECTOR WEIGHTS



COUNTRY WEIGHTS

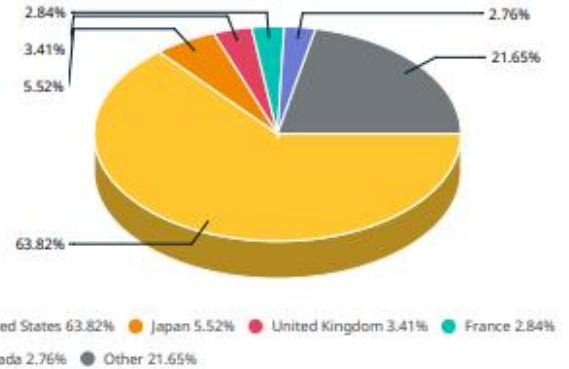
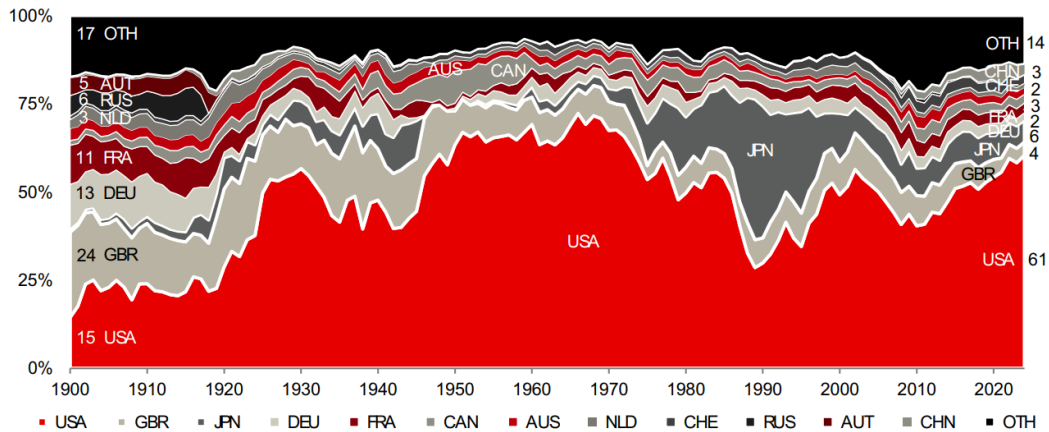


Figure 5 – Sector and country weights of the MSCI ACWI Index as of March 2024 - Source: MSCI

Having said that, the US market since the beginning of the 20th century has always made up a significant chunk of the global equity market. Paul Marsh and Mark Staunton, professors at the London Business School, & Elroy Dimson, professor at Cambridge University, update every year an ‘Investment Yearbook’ on financial returns across asset classes and geographies. In their most recent study, they highlight the importance of the US market since the end of World War I. As we can see on the graph below, the only exception to this was for a brief period in the late eighties/early nineties when Japan was the largest market in the world by market capitalisation. This did not last very long though, as the nineties saw disastrous performance by the Japanese market, while the American equity market performed very strongly driven by the emergence of the American technology sector¹.

Figure 3: The evolution of equity markets over time from end-1899 to start-2024



Sources: Elroy Dimson, Paul Marsh and Mike Staunton, DMS Database 2024 and FTSE Russell All-World Index Series weights (recent years). Not to be reproduced without express written permission from the authors.

UBS Global Investment Returns Yearbook: Summary Edition 2024

Another feature of the recent bull market is the increasing importance of extremely large companies. As of the end of March 2024, nine American technology companies make up nearly 20% of the global stock market, nearly 4x more

than the total value of Japanese companies. These companies tend to trade on high valuation multiples, as they have delivered exceptional earnings growth in recent years. They also have very solid business models and high margins. The danger is that a ‘strategy hiccup’ or shift in regulatory environment could quickly have a dramatic impact on these very large companies. As we saw with Meta (Facebook) in 2022 or with Tesla this year, any reversal in fortune can have a dramatic impact on stock prices when expectations are sky-high. On a more positive note though, these nine companies are also poster-children of the dynamism of the American economic system. A lot of them are more than simply American companies they are massive global organisations with a significant portion of earnings (if not the majority) generated outside of the United States. Most of these companies were also set-up by first-generation entrepreneurs very keen to disrupt the status-quo. Finally, a lot of these businesses were set up by immigrants, like Jensen Huang for NVIDIA (leader in AI electronic chips), Elon Musk for Tesla or Sergey Brin for Alphabet-Google.

TOP 10 CONSTITUENTS				
	Country	Float Adj Mkt Cap (EUR Billions)	Index Wt. (%)	Sector
MICROSOFT CORP	US	2,750.52	4.12	Info Tech
APPLE	US	2,332.26	3.49	Info Tech
NVIDIA	US	2,066.48	3.09	Info Tech
AMAZON.COM	US	1,553.38	2.32	Cons Discr
META PLATFORMS A	US	997.96	1.49	Comm Svcs
ALPHABET A	US	827.04	1.24	Comm Svcs
ALPHABET C	US	726.41	1.09	Comm Svcs
LILLY (ELI) & COMPANY	US	581.24	0.87	Health Care
TAIWAN SEMICONDUCTOR MFG	TW	555.24	0.83	Info Tech
BROADCOM	US	545.79	0.82	Info Tech
Total		12,936.30	19.36	

Figure 6 – Top 10 constituents of the MSCI ACWI Index as of March 2024 - Source: MSCI

As long as the United States remains a magnet for the most talented entrepreneurs with access to a deep pool of risk capital, the dominance of the US market is likely to continue. Nonetheless at TreeTop we will continue to have a global outlook on investment, as we have observed that in recent decades, a number of Asian and European companies have adopted some of the best practices of American capitalism.

In conclusion, while the global media continues to print scary headlines, the global economy as a whole continues to grow and corporate earnings remain strong¹. Risks are everywhere but opportunities abound at the same time. Some parts of the global stock market look expensive, though there are very cheap stocks out there which could become the heavy weights of tomorrow. What is sure is that inflation, like it has done for decades if not centuries, will continue to erode the value of cash over time. In a volatile world, a near certainty is that leaving cash sleeping in bank accounts is a near certain way to destroy wealth over time.

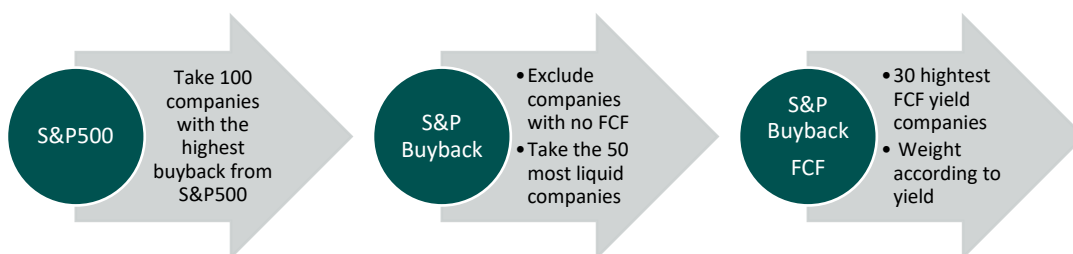
Our convictions

Beyond world equity trackers, we have always been looking for other ways to invest in the global stock market. A successful strategy consistently generates good returns and does not have excessive drawdowns when the market turns bad. The biggest challenge in investment, and the reason why so few people do it consistently well over time, is that investment styles go in and out of favour. It can be extremely difficult to distinguish between an investor who temporarily rides a successful investment trend and one who can consistently adjust their portfolio and generate durable high returns². In our experience, the latter is very rare.

In our previous newsletter, we discussed the use of **passive investment strategies** to generate consistent returns over time, **active investment strategies** where you need to be very strict with the selection of manager as most of them

² No guarantee of result or performance

underperform the market, **and finally quantitative investment strategies** where the investment manager is replaced by a set of systematic rules. Twelve months ago in our 1Q23 newsletter, we introduced our clients to the **S&P500 FCF Buyback**, the culmination of our search for a successful quantitative investment strategy. The major conundrum we needed to solve is to find quantitative factors which can lead to consistent outperformance across investment cycles. After months of research in 2022, the S&P500 FCF Buyback appeared to be the solution. The strategy uses a set of valuation criteria (free cash flow yield), liquidity and management input (share buybacks) to find the most compelling investment opportunities every three months in the S&P500. The process is summarized in the figure below and for a full description of how the strategy works, please refer to our 1Q23 newsletter.



The **S&P500 FCF Buyback** has several characteristics. First it is a highly concentrated portfolio with only thirty stocks, which are weighted according to their free cash-flow yield. At the beginning of the year, the top 5 positions made up 33% of the strategy and the top 10, 55%. Secondly, it is flexible and can adjust positions very quickly. A lot of investments are sold after only three months if there is better relative value found elsewhere. While this might be anathema to long term investors, the US market adjusts more and more quickly and it is not rare to see stocks move up 50% over short periods of time, meaning quick selling is sometimes required. A key advantage of this strategy over most traditional managers is that it does not suffer from ‘inertia’. A lot of investment managers start well but their performance gradually deteriorates as old underperforming positions start to accumulate. A quantitative strategy such as the **S&P500 FCF Buyback** does a complete ‘spring clean’ every three months. Finally, as we can see in the table below, the strategy has invested in every sector of the S&P500, but weightings can vary significantly.

	1/24	8/23	1/23	6/22	1/22	6/21	1/21	6/20	1/20	6/19	1/19	6/18	1/18	6/17	1/17
Com service	9%	3,8	1,8	6,2	1,7	10,8	1,1	2,1	1,4			2,2		5,9	1,7
Cons discretionary	15%	13,2	5,1	8	12,1	1,9	14	5,9	5,4	12,9	8,7	13,6	11,9	20,5	23,1
Cons Staples			1,2	2,1	3,5	3,3	3,1	1,3	3,5	6,8	6,1	4,3	5,7	12,6	5,4
Energy	34%	24,3	36,8	13,8	3,4				8,5	11,6	10,2	15,6	5,6		7,7
Financials	16%	38,5	35,8	47,6	40,7	36,7	40,4	73,2	21,8	37,7	32,7	27,9	47,3	29,7	19,2
Health Care	14%	17,4		12,2	7,8	18,1	11,9	2,5	8	14,5	12,1	6,8	8,2	12,7	6,1
Industrials	12%	1,2	1	2,1	8,3	11,8	7,4	4,1	20,4		14,4	6,5	10,9	6,5	23,6
Inf Technology		2,7	4,8	4,2	15,1	17,2	21,8	8,8	29,6	15,9	15,5	22,9	6,2	9,1	7,9
Materials		1,4	13,2	3,4	7			1,7	0,9				3,8	2,8	4,9

Source: Bloomberg au 22/01/2024
Données à titre illustratif uniquement. Les comportements de marché passés ne préjugent en aucune manière de leurs comportements futurs.

Figure 7 – Sector weights of the S&P500 FCF Buyback Index from 2017 to 2024 - Source: S&P, TreeTop AM

Green in the table represents the sectors which are overweight relative to their weightings in the S&P500. As of the first quarter of 2024, the strategy is overweight in consumer discretionary (15% compared to 10.9% in the S&P500), energy (34% compared to 3.9% in the S&P500), financials (16% compared to 13% in the S&P500) and industrials (12% instead of 8.8% in the S&P500). It had no investments in technology companies (while the S&P500 has 28.9% invested in these firms), no investments in consumer staples and no investments in materials. Over time though, every sector has been overweight at some point. Technology firms, for example, were overweight in late 2019 and early 2020, before their post-COVID boom.

All these investments, especially the larger ones, are also deep value stocks, with the two biggest positions trading on free cash flow yields of around 20% as of January 2024. This means that these stocks generate cash equivalent of 1/5th of their market capitalisation every year. Overall, the strategy has a free cash flow yield above 10% when the S&P500 has a free cash flow yield between 3 and 4%, making the strategy much cheaper than the overall US stock market.

Finally, the S&P500 FCF Buyback has had exceptional results in the past. Since February 1994, it is up 95x, while the S&P500 is up 18x, the NASDAQ 25x and the MSCI ACWI 8.4x. More importantly, it has generated consistent returns over time, generating double digit returns per year over most periods². As always, past returns are no guarantee of future returns and please contact your financial advisor to make sure you understand all the risks. Feel free to contact us for any eventual questions.

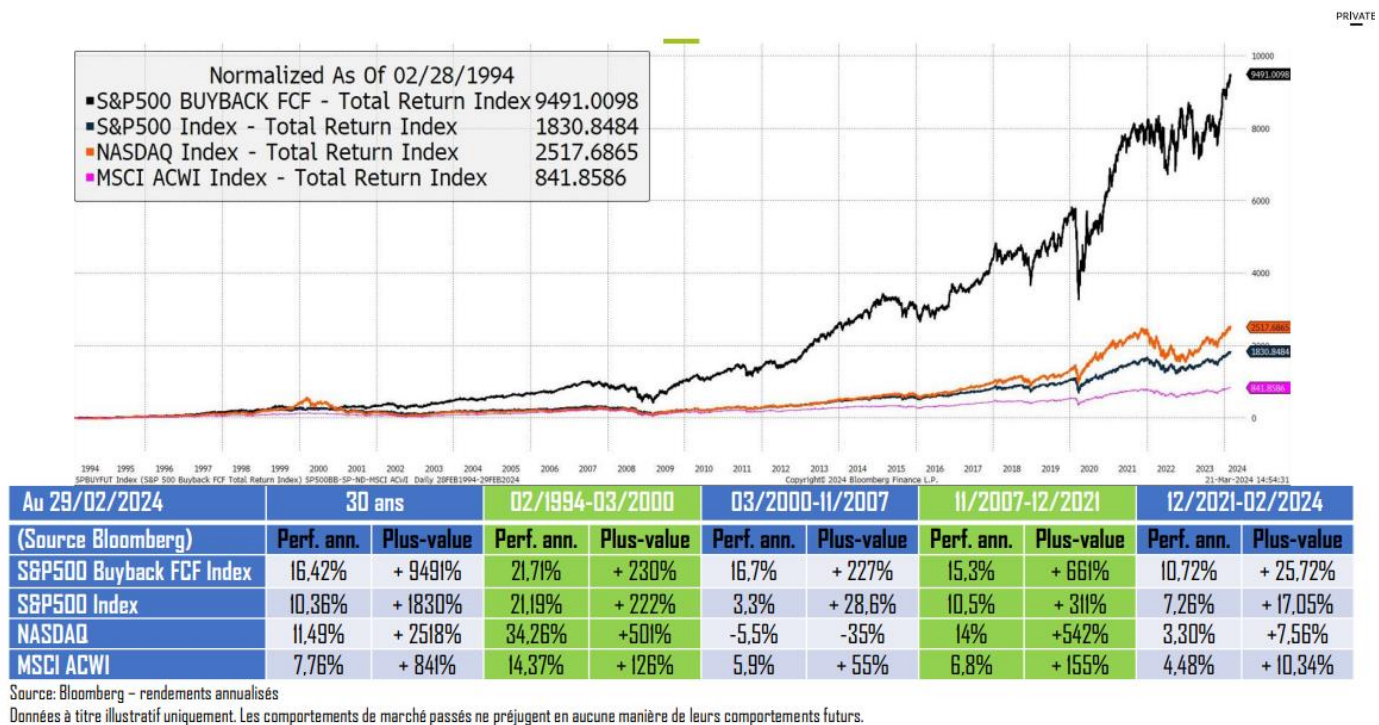


Figure 8 – Performance analysis of the S&P500 FCF Buyback Index compared to other indices - Source: Bloomberg

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Data & Information as of 28th March 2024

Published by TreeTop Asset Management SA, a UCITS Management Company pursuant to the provisions of Chapter 15 of the Law of 17th December 2010 – Registered office at 12 rue Eugène Ruppert L-2453 Luxembourg.