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FOURTH QUARTER 2023

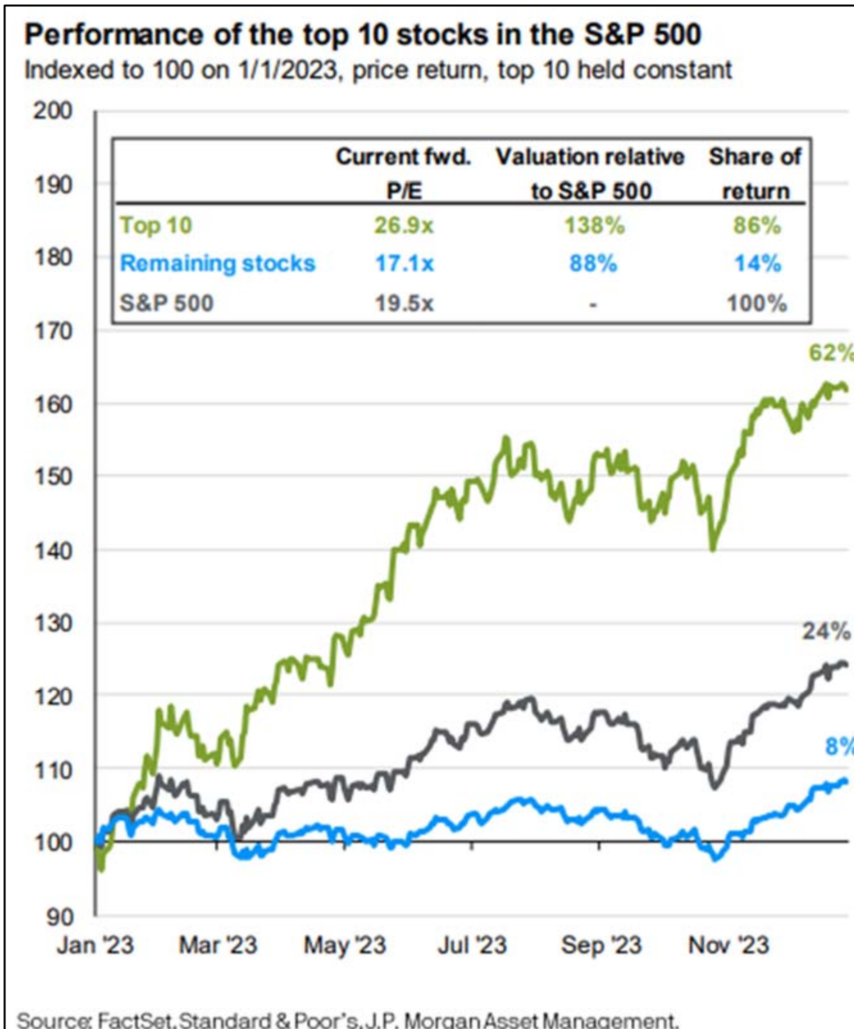
Index	Q4 2023	YTD
S&P/TSX Composite (C$)	8.1%	11.8%
S&P 500 (US$)	11.7%	26.3%
S&P 500 (C$)	9.3%	23.3%
MSCI EAFE (US$)	10.4%	18.2%
MSCI EAFE (C$)	8.0%	15.4%
FTSE TMX Universe Bond Index (C$)	8.27%	6.7%
C$ / US$	1.3520 to 1.3226 (2.2%)	1.3544 to 1.3226 (2.4%)

**** Index returns are total returns, including dividends.***

THE KINGS' LIMITATIONS

During the 11th century, King Canute ruled over medieval England, Denmark, and Norway. According to legend, King Canute was constantly showered with affection by his subjects. However, as time passed, he grew weary of the flattery from his courtiers who claimed he had control over all things, and he decided to show them the futility of such assertions. He brought his throne to the shoreline and sat there attempting to command the tides to follow his instructions. Of course, as expected, the tides continued to ebb and flow in accordance with their natural order. Canute's lesson to his admirers was that there are limitations even to a king's power.

2023 showcased the incredible divide in the U.S. equity markets between the modern-day "kings of the market" and the remaining 490 companies. Some of the winning titans include such household names as Apple, Amazon, Nvidia, Google, Facebook, and Tesla. As shown below, a staggering 86% of the S&P 500 index's 24% price return in 2023 can be attributed to just the top 10 stocks in the market, while the remainder of the companies accounted for only 14% of its overall return. Unlike the companies that made up the internet bubble of the late 1990s, these major contributors are profitable, growing companies with healthy balance sheets. Even though our view is that most of these top 10 may now be richly valued, there are a couple – notably Google and Facebook – that we still think are reasonably priced given their fundamentals. However, we saw a similar rise play out in 2021 with "The Magnificent Seven," only for the gains to be washed away in 2022. As such, we continue to place a large focus on prudent valuation, understanding there may be limitations to the success of the current market powerhouses.



At year-end, the top 10 U.S. stocks were trading at an expensive 26.9x current price to next twelve months (i.e., 2024) expected earnings ("P/E"), compared to the rest of the market at 17.1x P/E. As shown in the chart on the following page, even 17.1x P/E is slightly above the historical average for the S&P 500 index. Buying companies when they are, on average, so richly valued creates considerable downside investment risk, even for market dominant companies. Once-dominant players in many industries have been eclipsed over time: Nokia by Apple and Samsung, IBM by Microsoft, and Yahoo! by Google, to name a few. Like King Canute, these companies demonstrated their limitations: their size made them less nimble and less able to adapt to change in their respective industries. As Charles Darwin said, "It is not the strongest of the species that survive, nor the most intelligent, but the one most responsive to change." As we know, the modern world, especially modern technology, can change very quickly. The powerhouses of today will not necessarily be able to survive the disruptions of tomorrow.

Valuation measure	Description	Latest	30-year avg.*	Std. dev. over/under-valued
P/E	Forward P/E	19.51x	16.59x	0.90
CAPE	Shiller's P/E	32.43x	27.55x	0.79
Div. Yield	Dividend yield	1.54%	2.00%	1.33
P/B	Price to book	3.97x	3.11x	1.10
P/CF	Price to cash flow	14.82x	11.13x	1.64
EY Spread	EY minus Baa yield	-0.33%	0.04%	0.20

Paying inexpensive prices while still investing in good companies is key to protecting oneself against downside if or when limitations appear and are recognized and pounced upon by the market. A prime example during 2023 comes from Dollar General ("DG"). DG operates a chain of variety stores in the United States that offers a wide selection of low-priced goods, including household essentials, groceries, and general merchandise. A long-time market darling, DG was frequently praised for its astute operations, intelligent capital allocation, and consistent, sustainable, high-single-digit revenue growth driven in large part by new store openings.

Over the past decade, DG's ongoing success was rewarded with a growing P/E ratio. DG closed 2022 with a P/E of 21x, compared to a P/E of 18x for the overall market, and low-teens multiples for slower-growing companies. Unfortunately for DG, 2023 market analysis determined there might be an oversaturation of dollar stores in the U.S., suggesting less opportunity for DG to continue pursuing its main avenue for revenue growth: new store openings. The result? By the end of September 2023, DG's P/E had dropped to 13x as the stock plunged 58%. Anyone who bought DG's stock after 2019 lost money, and on average, the investor who bought in either 2021 or 2022 lost 52% of their capital. This happened *even despite earnings growing between 2019 and 2023*, because a market insight prompted investors to rethink whether DG's sky-high valuation was, in fact, warranted after all. When investors overpay for quality and growth, the downside can be ruinous if limitations suddenly appear.

King Canute implored his followers to understand that even the most powerful kings have limitations. Much like he could not control the tides, current stock market darlings will not be able to control a massive downward correction if limitations present themselves. At Evans we protect against that risk by focusing on inexpensive-to-reasonable valuations, and by being opportunistic when expectations for companies are already low.

REFLECTING ON 2023

2023 brought ample uncertainty to investors as economic developments affected markets globally. Notably, North American security markets seemed to be encouraged by inflation returning to the central banks' target rate of 2%. Although the latest Canadian inflation posting of 3.4% (in December) is still above this target, it is a far cry from the 8.1% inflation peak we faced in 2022.

The problem with this receding inflation, however, is that it was sparked by North American central banks increasing interest rates; such a move has historically tipped economies into recession. Since the start of 2023, the Canadian central bank has raised interest rates from 4.25% to 5% today. Higher interest rates increase the cost of borrowing money for homes, cars, and other loans, and these higher expenses for both individuals and businesses lead to slower economic activity. Just as the lower interest rates of the past decade led to a booming economy and roaring equity markets, the increase in interest rates over the past two years could have the opposite effect. As 2023 ended, market participants began to anticipate that central banks might lower rates more quickly than previously expected, while still avoiding a recession, which led to an exceedingly optimistic final quarter in global equity and bond markets. After peaking at approximately 5% in the summer, the 10-year U.S. treasury bill has now come full circle back to the same rate it was trading at in the beginning of 2023: 3.9%.

Our view on economic forecasting is that it is nearly impossible to predict outcomes consistently and accurately: there are too many unknown or misunderstood variables to consider. As we highlighted in our previous letter, we agree with great investors like Warren Buffett, Peter Lynch and Howard Marks when they say that economic forecasting adds little to no value over time. As such, we believe it is prudent to understand and find value in individual companies and take a conservative approach to economic inputs based on a long-term (50+ year) history.

There is still ample uncertainty in the markets today. How will the bifurcated S&P 500 index shake out? How will Artificial Intelligence shape businesses in the future? Will inflation increase or return to normal, and how will the central banks react? Through all this uncertainty, we don't try to make macroeconomic bets, time the market, or guess the identity of the "next big thing." Instead, we remain focused on investing in individual companies for statistically probable success in *any* macroeconomic environment. As shown below, the companies we own, on average, are more profitable, grow faster, use less debt, and are less expensive than the overarching market. At Evans we simplify this as "investing in better businesses, with less risk."

Evans Investment Counsel Portfolios Compared to Market Metrics at December 31, 2023								
	Canadian Equities		U.S. Equities		International Equities		Consolidated	
	Evans Canada	S&P/TSX Index	Evans USA	S&P 500 Index	Evans EAFE	MSCI EAFE Index	Evans Equity	Blended Benchmark
2023E P/E	10.5x	14.8x	16.4x	21.6x	15.0x	13.9x	14.0x	17.7x
2024E P/E	9.6x	13.8x	14.1x	19.6x	11.0x	13.8x	11.9x	16.4x
1-YR EPS CAGR	10%	7%	17%	10%	36%	1%	18%	8%
10-YR ROE	13%	9%	17%	15%	13%	10%	15%	12%
Price/Book	1.2x	1.9x	3.5x	4.5x	1.3x	1.8x	2.3x	3.1x
Net Debt/Equity	55%	54%	4%	64%	-6%	64%	21%	61%
Dividend Yield	3.4%	3.2%	1.6%	1.5%	3.4%	3.2%	2.6%	2.4%

"1-YR EPS CAGR" is an expected growth rate based on consensus analyst estimates

FINDING VALUE IN AMERICAN HEALTHCARE

In order to understand a recent purchase we made for clients, one must first understand the history of the American health insurance system – which is complex, having evolved over several decades. It began to take shape in the 1920s during the Great Depression. Baylor University Hospital in Texas is often credited with the first group health insurance plan in 1929, when a group of teachers in Dallas agreed to pay a monthly fee to the hospital in exchange for medical care. During the Great Depression and World War II, labour shortages led employers to offer health insurance to attract and retain workers. This gave rise to the employer-sponsored insurance model, and in 1943 the U.S. federal government made employer contributions to health insurance tax-deductible. These factors all contributed to a rapid growth in health coverage in the U.S.: in 1940, a mere 9.1% of Americans had medical health insurance; by 1960, that number had risen to 68.3%. In 1965, the Medicare and Medicaid government-sponsored programs were introduced to provide coverage to those not in the workforce or otherwise vulnerable.

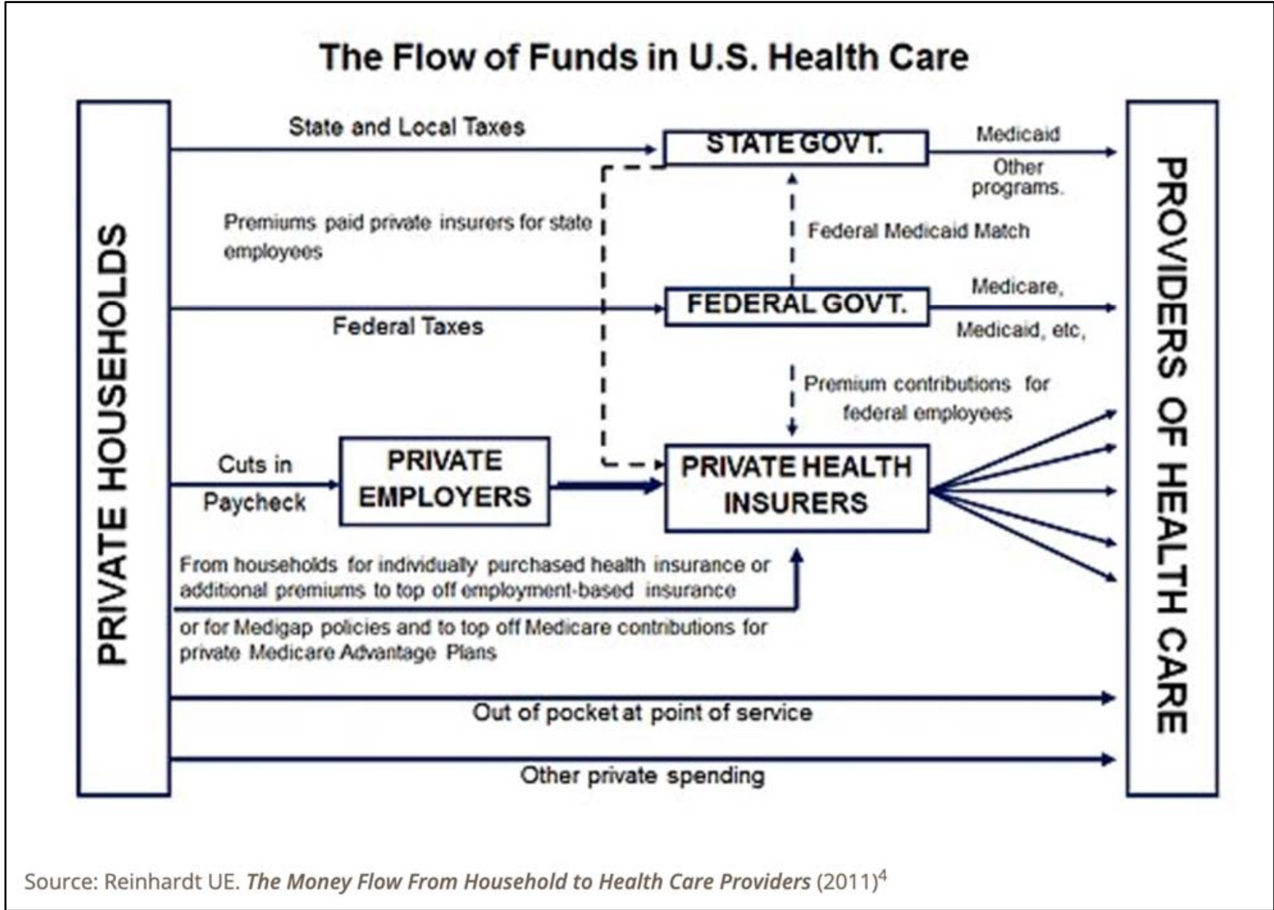
Today, **Medicare** is a federal health insurance program primarily for individuals aged 65 and older, though it also covers certain younger individuals with disabilities. Medicare is divided into different parts as outlined below:

- *Part A (Hospital Insurance):* Covers inpatient hospital stays, skilled nursing facility care, hospice care, and some home health care.
- *Part B (Medical Insurance):* Covers outpatient care, doctor visits, preventive services, and some home health care.
- *Part C (Medicare Advantage):* Private insurance plans that offer the benefits of Medicare Parts A and B and often include additional coverage, such as dental and vision benefits.
- *Part D (Prescription Drug Coverage):* Optional prescription drug coverage, provided through private insurance plans.

Medicaid, on the other hand, is a joint federal and state program that provides health coverage to eligible low-income individuals and families; in fact, it is the largest source of health insurance for many low-income Americans. In 2010, Medicaid was expanded under the Affordable Care Act ("ACA"). The ACA allowed states to expand Medicaid eligibility to include a greater number of low-income adults, leading to increased coverage in participating states. Over time, Medicare,

Medicaid, and employer-sponsored coverage have grown, and now cover roughly 92% of Americans.

So, how does the American health insurance industry operate today? As shown below, private health insurance companies receive “premiums”, either paid for by employers or funded through taxes. When an individual utilizes medical services, insurance companies cover expenses for part or all the service provided to the individual by their health insurance provider. These providers are integral to the U.S. medical system.



Source: Reinhardt UE. ***The Money Flow From Household to Health Care Providers*** (2011)[4]

National private health insurers include United Health, Centene, Cigna, Elevance Health, and Humana. All are publicly traded. From time to time, these companies become undervalued due to regulatory risks surrounding changes to U.S. healthcare, fear over unsupportive political policies, or a general transition away from healthcare stocks. We currently believe a lot of the sector may be undervalued given the tailwinds in the industry, pricing power, and the stickiness of their role in the U.S. healthcare system. As such, towards the latter half of the year we began building a position in Humana.[1]

Founded in 1961, Humana has grown to be one of America’s largest health benefits companies. It covers approximately 17.1 million members, including 5.8 million Medicare Advantage members. Humana is a full-service benefits solutions company offering plans for government programs

[1] *Some clients might not hold Humana due to asset mix or timing.*

(Medicare and Medicaid), employer groups, and individuals. Humana also has a mail-order pharmacy business, provides services via their 235 senior-focused primary care centres, and offers at-home care services. Humana has a well-diversified and growing business within the recession-resistant healthcare sector and should continue to benefit from an aging U.S. population.

Among the various health insurance providers, Humana was particularly enticing to us as an investment because Medicare Advantage coverage is a larger proportion of their revenue versus its competitors. Medicare Advantage coverage for individuals and groups comprises approximately 70% of Humana's total revenue, and over the past 5 years its Medicare Advantage business has grown faster than the industry average. Since individuals tend to prefer having vision, hearing, and dental bundled with their health coverage, Medicare Advantage looks to be favoured by most customers. Humana's management noted, "We have seen Medicare-eligible customers increasingly choose a Medicare Advantage product with penetration of total Medicare eligibles at 51% in January 2023 representing $473 billion in market size. This penetration rate is up 12% from 2018 to January 2023, and we expect high-single-digit growth rates for the Medicare Advantage industry through 2025." Further tailwinds supporting Humana's growth include more Baby Boomers becoming eligible for Medicare, coupled with a continued rise in American healthcare costs.

Moreover, Humana's financial metrics and valuation are compelling. Humana has an 18-year average revenue growth of just under 12% and average earnings per share growth of 28% over that same period, due to meaningful operating leverage and share repurchases. In addition, Humana has a fortress balance sheet, with US$90 per share of net cash (US$11 billion total value) versus a current share price of US$440. Excluding cash, Humana trades at a P/E of 12.5x versus the market's 19.5x P/E. This is exceedingly low for Humana's historic growth rates. The market is effectively pricing the company for no growth. Warren Buffett has often mentioned he doesn't try to bet on anything too extravagant or complicated in the markets, but instead looks for one-foot hurdles to jump over. Our view is that Humana is a one-foot hurdle.

With investments like Humana, we continue to focus on providing great value to clients through prudent investing and downside protection. Ignoring hype or overcrowding in the market, we will continue to act as careful stewards of your capital, remaining patient as we look for bargains and great companies at inexpensive prices.

Thank you for your continued confidence and support,

The Evans Team