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INVESTMENT REPORT
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CT CAPITAL LLC

PORTFOLIO REVIEW

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INTRODUCTION

Ultimately, a heavyweight global investing title fight between fear and greed ends with both on the canvas. Yet, rounds may be won by overvalued firms under a variety of circumstances, including the past quarter in which the world's Central Banks continued with unified programs of quantitative easing.

The account rose 8.15% for the quarter, net of all fees.

When the world's Central Banks feel free to borrow at a record pace or print cash with frequency, our portfolio will rise more slowly than benchmarks as they are not as exposed to credit risk as stocks in general. Passing through investment and economic cycles, you should anticipate that our companies will provide rewards over benchmarks as Central Banks return to more normalized positions or even perhaps the result of inflationary consequences taken during this dramatic period of unified worldwide quantitative ease. (see our section on debt).

Q1 was a period when weak credit, those near bankruptcy, leveraged, or working off of interest rate declines (e.g., housing) were aided by the monetary authorities. Central Banks' bringing an "everything rise" financial marketplace, where boats with leaky holes stay afloat, was most apparent in Donald Trump's "Truth Social" shares.

COMMENT ON PERFORMANCE RESULTS

For the past three years, our account has outperformed the Russell 1000 Value Total Return index by 566 basis points, and for the past five years, it has outperformed the benchmark by 3,450 basis points! Since inception, we have outperformed the Russell 1000 Value Total Return by approximately 200 basis points annually. We have outperformed comparable large-cap value funds over the last five to ten years**.**

During the past five years, the account has significantly outperformed the Russell 1000 Value, the Wilshire Large Cap Value Fund, the Vanguard Large Value Index, and the JP Morgan Large Cap Value Fund. Throughout its investment history, it has consistently outperformed the Newberger Berman and Putnam Large Cap Value Fund. We believe that no public mutual fund has outperformed CT Capital over the past five years with the same level of risk (cost of capital). It's worth noting that non-traded funds may perform well during specific cycles.

If you haven't had a chance to read it yet (“Is the S&P 500 a Useful Comparative Benchmark?”), please let us know; we'll happily resend it to you. Considering the limited number of dominant firms in that index, **it is clear that the S&P index does not serve as a reliable indicator and should not be referred to as such. It is not unusual for the shares of one technology firm to outweigh the investment performance of over 200 other diversified firms**. However, it is important to note that the S&P 500 has the potential to significantly underperform, as demonstrated in our account's historical performance two years ago.

The account benefited from its chip exposure, including holdings in Applied Materials and MKS Instruments, and those benefiting from normalizing interest rates/housing, such as TransUnion and Mohawk, up more than 20% for the quarter.

Given general economic conditions, valuation, and the eventual end of QE, we have been lowering the exposure of our technology, which is all contained within our models. Sales included Cognizant and Open Text and reduced exposure to Amazon and Applied Materials, given firms coming on our Buy List.

The biggest disappointment of the quarter, if not the last four years, was the need to sell Accenture, which had increased in value by 9X since the original acquisition. We could not sell before the 10-Q was filed, which revealed the adverse effects on their financial structure (credit, cost of equity, and financial cushion) of about thirty-five smaller purchases. Significant purchases are disclosed, enabling us to account for the credit impact.

Positive news often saw several of our holdings react hypnotically, in many cases preferring risk. Corning shares fell the day Apple announced it was disbanding its attempt at display manufacturing, **as its new generation of coating is superior to the current "Ceramic Shield," which will be unveiled in the iPhone 17.**

Our insurance firms still see rates increasing under most policies, except for D&O (Directors and Officers), workman’s compensation, and specific cyber policies. Global warming, the economy's health, additional capacity, and sovereign risk will drive rates forward.

Our defense companies (described in a later section) have shown substantial and improving financial metrics and noteworthy, sustained improvements in backlog increase during the quarter. Surprisingly, despite growing and record order rates amidst increasing geopolitical uncertainty, investors ignored military firms relative to fads. On the other hand, military shares should perform well for many years as the EU significantly boosts defense spending and has already begun doing so.

The increasing dissatisfaction of the free world with China (rare mineral refining) and the Middle East’s oil dominance will ultimately result in hydrogen becoming the most effective substitute for fossil fuels. This trend will occur progressively yet consistently. Airbus, EasyJet, and Rolls-Royce have called on the UK to offer further funding for hydrogen infrastructure this past quarter.

Cummins successfully tested its first fuel cell-hydrogen-powered locomotive for the Austrian Railways, replacing typical diesel generators and serving as the primary power unit.

Our holdings in hydrogen-focused names (Air Liquide, Air Products, Linde, and Cummins) have strongly contributed to overall performance. Given that projects are underway, a few are near completion, and there is a strong demand for this form of energy, there is little reason not to believe that significant price appreciation lies ahead.

Our healthcare firms slightly underperformed benchmarks, consistent with presidential election cycles. For instance, Bristol-Myers shares declined despite several positive announcements, including the first T-cell therapy for multiple myeloma. Merck, however, hit a record high. Shares of QuidelOrtho were the portfolio’s largest laggard after reporting a disappointing respiratory season (flu, COVID, strep) during a warm winter, for which there is an association. They are growing share in these areas, so their growth should resume as seasons normalize. Their non-respiratory segment continues to show strong growth and should increase its share valuation over the forthcoming years.

As the portfolio comprises firms with considerably greater value per investment dollar, there is little reason to believe the account will not outperform benchmarks.

THOSE MUST HAVE, CAN'T MISS INVESTMENTS

As we often note, a calendar quarter, year, or even a more extended period cycle has little impact on our fair value assessment and typically none over the long run for stocks in our portfolio**.**

The first quarter of the year is usually an odd duck since analysts and investors are required to project how the year will work out overall. Impairments are thusly rare. Under GAAP these estimates are required. And so, such guesses or estimates lead to improper valuation multiples and deceptive, albeit GAAP-compliant, interim reporting to shareholders. (Please read the later section: Interim Reporting)

The year's initial quarter saw AI and weight-reduction stocks as investment preferences. There was no spillover to those firms' clients.

Yet, Julie Sweet, the Chair of Accenture, which we noted above was sold during the quarter, said last week that AI is years away from seeing a significant business transformation given the changes required, from systems to hiring those with the right skills.

One could fill a phone book with the number of "can't-miss" enterprises that sucked investors' cash and are now in the annals of history. Indeed, yellow-page phone books—once a booming industry—serve as another illustration.

Most recently, investors in Tesla, Xpeng, Fisker, Lordstown, Nio, Rivian, and Lucid had to learn this lesson, as have the byproduct firms, such as the charging companies. Back then, investor/analyst price targets on Tesla frequently exceeded the stock split equivalent of $1,000.

New technologies ultimately face unforeseen risks.

The increasing prevalence of AI will likely lead to significant disruption or possibly the shutdown of certain businesses. Subjecting firms to costly lawsuits due to an error or software attack on their AI that leads to financial loss would have detrimental consequences. Up to this point, cyber security organizations have still been unable to completely thwart attacks, including those on the Pentagon and UnitedHealth in the most recent quarter.

PRUDENTIAL'S "HIDDEN" ASSET

An area receiving scant attention from analysts, other investors, and the financial press is pension risk transfer, whereby a firm that wishes to alleviate its pension liabilities sells the risk. Prudential is the leader in the US in such deals, which can be exceedingly complex. **CT Capital has a deep knowledge of pension transfers and the obstacles involved, including those with military sales.**

During the most recent quarter, Prudential completed a $5.9B risk transfer through the purchase of annuities for Verizon. They also completed a pension risk transfer for Shell in a $4.9B deal. Pension risk deals exceeded

over $100B worldwide during 2023 and are an excellent way for firms to lay off pension obligations wholly or partially.

Liability pricing can be tricky, depending on the assets in the pension fund and other factors connected to the employees attached to it. Prudential has been a buyer of jumbo-sized ($1B+) deals, an excellent value-add in this growth division. As pension liabilities drop, we should see many more firms wishing to dissociate from the liability, enabling the Prudential division to generate substantial cash from operations.

As interest rates rise, the incentive for firms with pension liabilities to transfer the debt to firms like Prudential grows substantially.

INTERIM ACCOUNTING

Under GAAP interim reporting standards, a CFO's forecast for the entire year is required. Many of these estimates end up well off the mark disclosed to shareholders during the year, often creating irrational expectations and strange Q1 stock performance compared to year-end.

A primary driver of the estimate is the requirement related to the year-end tax rate. The interim estimate must also consider local credits, benefits pertaining to various income types, valuation allowances, and federal and international provisions for each company's business jurisdiction. Last quarter, Aptiv reported a nearly $2B non-cash tax gain on the intercompany transfer of intellectual property.

Interim period accounting is, therefore, quite complex and requires scores of estimates into areas that are yet to come, from business conditions to the effect of GILTI based on foreign reporting.

Our worksheets evaluate the stability of a firm’s reported (GAAP-based) tax rate and its cash tax rate over many years, providing us with a comfortable estimate.

Certain items or events are expressly excluded from annual estimates because they cannot be reasonably estimated or are not part of the firm’s normal operating cycle, and, therefore, the related tax effects are recognized discretely, meaning they are excluded from the numerator and underlying pretax book income or expense, if any, is excluded from the denominator.

Under interim reporting accounting standards, **the statement of cash flows may be abbreviated starting with a single figure** of net cash flows from operating activities and showing cash changes from investing and financing activities individually only when they exceed 10% of the average of net cash flows from operating activities for the most recent three years. When this occurs, **our more comprehensive cash flow set provides valuable insight.**

We, therefore, believe we have a significant advantage in our ability to convert to cash-based results from GAAP and the firm’s non-GAAP reporting. Goodwill and intangible assets have little value unless they can be leveraged to produce free cash flows, as per our adjustment. The same is true of all balance sheet items.

Those few top firms primarily responsible for S&P 500 performance may raise their depreciation periods to prop up the GAAP income they report to shareholders. They are also under the microscope of foreign tax authorities for various reasons, including competition against local firms and conformation to tax codes.

Since the top 10 S&P firms are not capital-intensive compared to the market in general, the standard ROIC may not be appropriate, making our proprietary return on economic profit a more appropriate yardstick. For example, in its most recent 10-K, Apple shows $130B in cash, only $62B in equity, and $44B in property and equipment, showing book value as inappropriate when estimating its fair value.

We evaluate economic profit as a percentage of other metrics, including revenues, R&D spending, etc. Our definition of economic profit is based on our adjusted free cash flow,[1] including essential adjustments to the reported financial statements and classification errors in the statement of cash flows.

DEFENSE STOCKS

Sadly, peace has not prevailed since the creation of man. So, the world is fully prepared to resolve the underspending that has been part of its fabric for generations. Last week, the US said China is building its nuclear and military arsenal "on a scale not seen since WW2."

Despite the significant backlogs and above-average earnings recorded by defense industry businesses, our shares saw surprisingly neutral market swings in the first quarter of this year.

To cite one example, RTX's foreign military business is growing at a rate only beginning to be noticed by investors. Germany placed a $1.2 billion order last week for more Patriot missiles, while the Pratt & Whitney division is seeing unanticipated growth in its commercial seating business, which currently supplies 14 airlines. However, this division is barely noted in RTX's financial filings.

Proving to be the world's most technologically advanced jet fighter, Lockheed's F-35 is poised to become the most popular fighter plane globally, recently receiving the full-production go-ahead with the Pentagon.[2]

BAE Systems, our only foreign-based defense firm, saw its backlog increase by 18.5% in 2023, boosted by demand for its fighter jet support, missiles, and AUKUS submarine programs.

Notably, major defense companies have decided to withdraw from participating in the bidding process for unpredictable fixed-price contracts. These contracts have been quite costly for shareholders, leading to consistent and substantial losses reflected in the lack of growth in military shares. Despite having legacy contracts to fulfill, the business is expected to generate profitable cash through the transition to more favorable cost-plus contracts, even with SpaceX's growing market share. This is especially applicable to business dealings with foreign governments.

Due to the lack of top contractors with the engineering know-how prepared to take on large-scale projects involving considerable capital outlays, **our assets in the sector represent the military's limited manufacturing option**. This is good news for our companies since it indicates that the government would be responsible for project development losses and that profit margins will be more closely guarded.

With China and Russia's defense expenditures growing and the Kremlin threatening the use of nuclear weapons in the broader conflict, the free world has little choice but to increase military budgets. I**t has been estimated the EU needs to spend an additional $41B a year to meet the 2% target![3] So, even if US defense spending stagnates, our holdings are in an excellent position to see expanding production and backlog.**

BOEING

We understand that finding Boeing in the portfolio may surprise you because we are a company that invests as much time as feasible in risk to the cash flows.

[1] see "Security Valuation and Risk Analysis" for the formula and other relevant information.
[2] Some years ago, I was retained to review Lockheed, resulting in a takeover attempt. Simmons' Takeover Bid Defeated, Lockheed Says - Los Angeles Times (latimes.com)
[3] Europe faces €56bn Nato defence spending hole (ft.com)

No other company in the United States has reached the same level of importance as Boeing. Its contributions to our country are unparalleled, from manufacturing commercial airplanes and exporting them, to its crucial role in our national defense. Put simply, the US must safeguard Boeing, a vital defense manufacturer and the sole large commercial airline manufacturer, particularly as military risk becomes a growing concern. We certainly cannot afford to lose another major employer to the Chinese industry.

Therefore, the FAA will ensure that Boeing fulfills its safety objectives within a reasonable timeframe, possibly in the next two or three quarters. This should not be a challenging task given Boeing's extensive experience and the crucial requirements of its clients. We understand that the cash flow generated from commercial production safeguards their defense side to execute their fixed-price projects, although it may pose a short-term risk. However, we remain confident that this risk will be effectively managed despite occasional negative news coverage. Our analysis of Boeing is centered around security analysis, considering its risk measurements in relation to various factors and historical financial returns.

Inasmuch as we rely on our credit work much more than on the NSROs (credit agencies S&P, Moody’s, etc.), our longer-term approach clearly tells us Boeing shares offer strong value. Our adjusted cash flow models consider an extended period of time while assigning an appropriate level of risk to the discount rate when assessing fair value.

Thus, there is no reason to anticipate that the company's shares will not see a significant increase in valuation and cash flow over the balance of the decade, particularly given the growth in foreign defense orders and the fact that, according to the company's most recent presentation in London on March 20, their commercial customers are still mainly sticking with them. Some clients may be lost but will have every opportunity to return, primarily motivated by the US’ relative importance as a trading partner and a military powerhouse. However, margins will suffer in the immediate future (calendar year 2024) as they are offering client discounts alongside their added costs as issues are resolved with FAA compliance.

Boeing could reap more significant benefits from separating its two business segments—commercial production and defense. Even while the motions are not as straightforward as they appear on their face, including financial, we believe the FTC and DoD would welcome such a deal. Such an action would have a significant direct and large positive valuation impact on shareholders, given the return on profitability with cost-plus deals.

WHEN STOCK VALUATIONS CLIMB, EXPECTED RETURNS SHIFT

Stocks hit record highs during the quarter. While that certainly cheers existing holders of equity and convertible securities, we show below the impact on various financial metrics:

- The **firm’s** cost of equity drops as the firm can float a reduced number of shares to raise a similar amount of capital. If interest rates have risen, the capital structure could improve as equity replaces debt.
- If the firm is still intent on repurchasing shares under an existing program, its cost of equity rises, mainly should debt be utilized, closing out some value-adding business combination.
- **To the investor**, their expected return may be lower should the firm be closer to the fair value estimate combined with share repurchase.
- Stock-based compensation is impacted as outstanding shares are purchased at the strike price upon the issue, giving cash to the firm but likely offset should the firm choose to offset dilution. This could impact credit.
- Tax implications could benefit the firm as shares are exercised. The employer is generally eligible for a tax deduction equal to the full amount of the stock minus the exercise price when the employee vests in the restricted stock or the stock's intrinsic value when the option is exercised. This could also affect deferred tax accounts.

- The lower firm cost of equity could induce the firm to issue the high-priced equity merely to provide additional cash. In such a case, its risk profile may be altered depending on how the cash is ultimately utilized.
- The *relative* cost of debt could be reduced as creditors view the firm as being able to sell equity to repay obligations, also raising the firm's credit rating.
- The cost of acquisitions could drop if the firm can finance the deal with a lower cost of equity, especially if the target valuation rises at a lesser rate.

DEBT

According to Moody's Research, the $1.87 trillion in rated debt that US speculative-grade companies have expiring in 2024–2028 makes our companies appealing to creditors and investors alike. When you combine the growing US Treasury debt with the avalanche of maturing investment-grade debt, our companies should be in a reasonably strong position. Bond issuance would increase if M&A activity remained robust, and record levels of new and rollover debt are already starting to enter the fixed-income markets.

We employ our cash-flow worksheets centered around adjustments to the public financial reporting. Figure 1, which shows EBITDA for Warner Bros. Discovery, portrays a robust picture contrary to its actual credit under our models. Our efforts have produced a true-up to the company's stated risk, credit, and cash generation.

Figure 1 Warner Bros. Discovery-Why EBITDA Is Useless Metric

The table below presents our Adjusted EBITDA by segment (in millions).

	Year Ended December 31,		
	2023	2022	% Change
Studios	$ 2,183	$ 1,772	23 %
Networks	9,063	8,725	4 %
DTC	103	(1,596)	NM
Corporate	(1,242)	(1,200)	(4)%
Inter-segment eliminations	93	17	NM

Fitch has now downgraded credits for six straight quarters[4], a drop confirmed by our models, which we believe to be more stringent.

On a positive note for our holdings, should the Senate approve the House measure and at least temporarily alter Section 174 related to amortization of specified R&D and bonus depreciation, we should see an immediate upward revaluation to most of the firms in our portfolio. The list of permitted expenses in the measure has also been expanded.

How robust are our credits? For its $13B bond issuance this quarter, Bristol-Myers received nearly $85B in demand. Considering how heavily almost every firm (including their supply chain and clients) depends on credit, this level of acceptability is encouraging for our portfolio in the event of a downturn in the financial markets or the economy. Laboratory Corp. of America, which we do not own, recently stated that refinancing its existing debt would result in a 10 percent rise in interest expense; the outcome is that those with lower than our portfolio credit will be forced to pay higher than on-the-books interest rates.

Thus, although the US economy and job market are growing, there will inevitably be a clash between the Treasury and the private markets since the **federal deficit is growing much quicker, rising 16% as a percentage of GDP in the past two years**. There will be a point when the financial markets react to higher interest rates.

[4] North American Corporate Downgrades Exceed Upgrades for 6 Straight Quarters (fitchratings.com)

Also on the credit side, many firms are being cited for audit deficiencies, making our credit work in this area even more important.

The Public Accounting Deficiency Board reported Deloitte, EY, and PwC had an average deficiency rate of about 24%, up from roughly 13% a year earlier.[5]

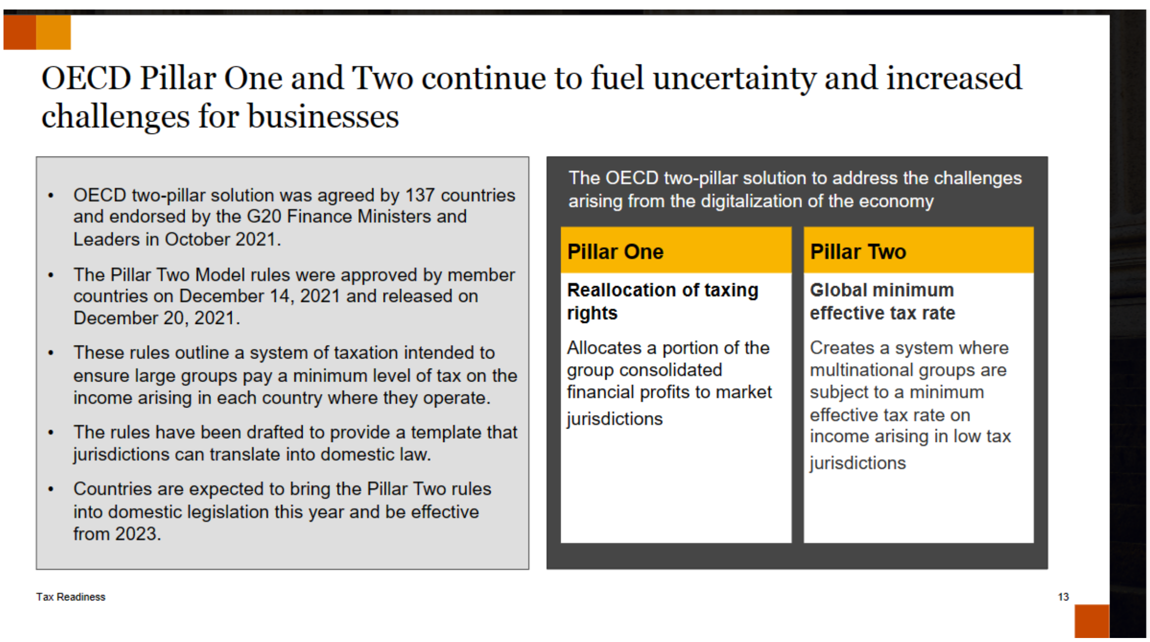
PILLAR TAXATION

The 15% minimum tax under Pillar 2 is currently in place, with more than 140 nations having ratified it**; firms must pay that minimum in each jurisdiction where they do business regardless of the rate they pay elsewhere**. Our large holdings conduct business in the EU, Japan, and other nations where Pillar taxation has taken hold.

Unlike the US, which bases its tax on worldwide revenues, avoiding a minimum 15% tax in every jurisdiction will be challenging, even though businesses have considered it for some time and have looked for ways to lower the impact (Table 1). While some firms might attempt to obtain credits, subsidies, tax agreements, or other ways to lessen the effects, this will prove difficult given the current restrictions. A number of corporations have already mentioned that their cash tax payments will soon grow; we feel that not many US analysts have looked into this situation in detail.

PILLAR taxation is comparable to the 15% Corporate Alternative Minimum Tax (CAMT) imposed by the Inflation Reduction Act in the United States.

Table 1 Pillar Uncertainty



Source: PWC

[5] PCAOB | Driving improvement in audit quality to protect investors (pcaobus.org)

We know of firms in our portfolio that are likely to be impacted and require additional taxation. It will be interesting to see how impacted corporations handle this in their upcoming shareholder meetings, financial filings, and press releases.

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