

Committing to a Long-Term Strategy in the New Year

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It is prognostication season once again for market commentators. Nearly every financial publication this time of year includes forecasts for everything from stocks to bonds to GDP growth, inflation, employment, interest rates, election season, and geopolitical unrest.

However, an investment strategy or asset allocation that relies on correctly forecasting the short-term behavior of asset classes is extremely unlikely to endure. By nature, equity markets are unpredictable over short periods of time—volatility is the price investors pay for higher expected returns.

Fortunately, if one can lengthen the time horizon of their investments, history has shown that the potential outcomes in the equity market are predictably tilted toward success. The day-to-day and year-to-year fluctuations of the portfolio and market do not disappear, but over a decade, stocks fairly reliably reflect the underlying business value that has been generated.

If we are willing to make any prediction, it is that we believe a portfolio of great companies with sustainable earnings power will generate strong risk-adjusted returns over a full market cycle. While hardly a controversial statement, building such a portfolio requires discipline and patience. There can be relatively extended periods when there is a disconnect between the fundamental value being created by a company and its stock price returns. Filtering out the noise of our daily mark-to-market world requires a philosophy as to what creates value over time and a commitment to that philosophy—especially when it is out of favor with short-term market participants.

The observation underlying Riverbridge's investment philosophy is that there is a steady thrum of innovation that permeates our economy. In particular, we have a fondness for stable and defensible businesses that provide high-value—even mission-critical—products and services that increase their customers' efficiency and productivity. Many of these companies do not attract much attention from the popular press but have carved out an attractive niche in their area of expertise. Riverbridge manages portfolios across the market cap spectrum, and our Investment Team identifies companies of all sizes we believe can achieve high and increasing returns on invested capital over

a full business cycle. Regardless of two companies' current relative size, revenue, or profitability, if one consistently achieves higher returns on invested capital than the other over a decade, it will build more business value; this is the definition of earnings power.

To uncover earnings power, we seek companies with time-tested characteristics that we believe are predictive of long-term value creation. First, in every holding, we look for companies capable of internally financing their growth, which allows them to control their own destiny to the greatest extent possible and insulates them from higher interest rates. Relatedly, to be a candidate for the portfolio, a company must be profitable at the unit level and be capable of selling more of what they do every year, regardless of the broader economic environment. As such, our portfolios tend to be less exposed to the more cyclical areas of the economy. We find these less economically sensitive business models by looking for companies with a strategic market position. Much of our hands-on research process is dedicated to understanding how customers, competitors, employees, and strategic partners perceive a company and its management team. We prefer companies with differentiated, non-discretionary offerings that customers will consume in good times and bad.

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When investing in businesses meeting these criteria, it is not incumbent on the Riverbridge Investment Team to forecast when the Fed will lower interest rates, whether we will experience a recession in 2024, or what the outcome of the presidential election will be. Sound investment strategies are built to work under a wide range of possible outcomes—they are designed with the knowledge that the future is dynamic and unpredictable. The story of capital markets and market-based economies is one of cycles. A successful investment approach is one that will endure through and across those cycles.

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