2023 Annual Shareholder Letter

During the fiscal year ending October 31, 2023, US equities attained modest gains, recovering from a poor market in 2022 where aggressive Federal Reserve action, recession fears, and persistent inflation hurt stocks. Over the current fiscal year, the S&P 500 Index rose 10.14%, driven by large-cap technology stocks and supported by healthy consumer spending. As more evidence emerged showing inflation declining without an increase in unemployment, stocks rallied. Investors have begun to anticipate the end of the Fed's tightening cycle. For now, fears over a policy mistake or sharp recession have been replaced with expectations of a soft-landing or mid-cycle slowdown. Elsewhere in the stock market, energy stocks, which had benefited from supply constraints and inflation following the pandemic, suffered the most in 2023, reversing two years of strong gains.

During the coronavirus pandemic, global policy makers struggled to balance the uncertain economic outlook and eventual unintended consequences of their interventions. The deference to excessive monetary and fiscal stimulus, when compounded by supply chain challenges and labor shortages, caused inflation to spread globally towards the end of the Covid era. The battle to contain this inflation encompassed most of the past two years. In March of 2022, the Federal Reserve initiated a series of sizable interest rates increases. Ultimately, the influential US Fed Fund overnight lending rate would climb from 0.25% to 5.5% in just 17 months. The aggressive steps weighed heavily on US equities in 2022, but have indeed suppressed inflation, all without tilting the economy into a recession or collapsing job growth. Chairman Powell deserves credit for the progress thus far.

One of the leading forces behind the rise in US equities during the fiscal year was the frenzy behind ChatGPT and the proliferation of Artificial Intelligence (AI). With advances in machine learning, software and processing power, AI has emerged as the next great technological innovation. We do not disagree that its potential is exciting, but our enthusiasm is also tempered by the familiar fever of a new highly hyped technology, its impact on near-term earnings, and extreme valuations that accompany the fever. We've seen similar frenzies behind digital printing, virtual reality, cryptocurrency, augmented reality hardware, big data and more. Nevertheless, all things AI have captivated investors and the year's top performer are all considered prime beneficiaries.

While the profit potential for AI is still too early to ascertain, Oak Associates generally prefers to participate in newer technological trends through large-cap technology leaders with exposure, or the ability to make a significant monetary commitment to the opportunity, rather than dedicated IPOs or perceived "pure-plays" in the space. Time and money are two very potent competitive threats and the historical record is littered with exciting firms that were unable to endure the path to profitability. We continue to monitor the opportunity and will make investment shifts as needed.

Significant changes to the investment landscape in 2022/2023 are likely to have long-lasting repercussions for more speculative segments of the equity market, specifically: start-ups, high-valued venture backed firms, and not-yet profitable small-caps. The onset of the Fed's 2022-2023 tightening cycle ended the nearly decade-long period of Zero Interest Rate Policy (ZIRP). With rates close to zero, borrowing was inexpensive and institutional investors were enticed into segments that offered return profiles now unavailable in standard fixed-income assets. Hedge funds and venture capital thrived as alternative asset managers captured market share. Venture firms were able to raise capital and seed businesses while also offering a very tolerant outlook towards profitability or exit IPOs. With the cost of capital now significantly higher, the era of unlimited access to cheap financing and deferred return expectations is likely over. Further threatening the start-up industry was the collapse of Silicon Valley Bank and the potential regional banking crisis that developed in the first-quarter of 2023.

With prevailing short-term interest rates pushing 5%, the capitalization of several banks came under pressure as customers withdrew demand deposits in search of better short-term yields. This occurred at a time when the value of long-term balance sheet assets was also collapsing. The practice of borrowing short to lend long requires an upward sloping yield curve which was upended by the Fed's inflation fight. In a fractional banking system with a modern twist, this led to an electronic bank run at Silicon Valley Bank (SVB), a venture-capital focused California bank. Oak was not an investor in SVB. The sharp change in rates, along with poor risk controls, hedging, and liquidity, precipitated a series of bank failures, resulting in the seizures of several institutions by the FDIC. The threat of a wider banking crisis lingered in Q2 2023, hampering financial stocks, but the FDIC's actions appear to have curtailed the potential contagion.

The impact of rising interest rates over the past fiscal year also wreaked havoc on bond investors. The popular iShares 20+ Year US Government Bond ETF lost more than 10% in the fiscal year and is down 40% over the past two years. Fixed-income investors are now confronted with the prospect of the Fed keeping interest rates "higher-for-longer". When combined with heightened polarization in Washington and discord within the House of Representatives, which is responsible for appropriations and government spending, risk over a government shutdown, the long-term viability of social services programs, and overall credit worthiness of US-Government securities have all affected the globally important US government bond market and US greenback.

With the tremendous amount of economic tightening imposed over the past two years, and massive withdrawal of quantitative stimulus, the risks of an eventual recession remain. Thus far, a healthy consumer and strong job market has carried the economy. Early signs of increasing credit delinquencies, falling savings rates, and tougher lending standards are areas of concern to watch. Yet, corporate profits have remained strong and valuation levels are not unattractive to warrant a major valuation reset. Pockets of hype in technology and pharmaceuticals are somewhat speculative, but the overall sentiment towards equities is not extreme. With more progress against inflation and the interest rate tightening cycle now on pause, an economic slowdown may remain elusive for a while longer. As always, geopolitical events can be disruptive and the risk of regional problems expanding into bigger conflicts persists. These developments are always hard to assess or predict.

Looking into 2024, the outlook for equities depends on continued success against inflation. The restrictive fiscal and monetary conditions have done their job, but should the Fed add more constraints to prevent an inflation rebound, equities could falter. The US economy has always been driven by the consumer and a continued strong labor market bodes well for consumer confidence and spending. A decline in mortgage rates would also recharge the housing and construction sectors. Given the severity of tightening already in the economic pipeline, we do believe that it is probable CPI and inflation have likely peaked and should continue to trend lower in 2024, albeit not always in a straight line. While market participants continue to anticipate that the Fed will soon unwind their tightening, this too may be premature unless deeper economic stress develops. Although current interest rates may be considered restrictive relative to the past decade, compared to historical levels, they are not extreme. We suspect the Fed would prefer to preserve the reclaimed power that comes with its ability to implement future interest rate cuts for as long as possible.

To endure the economic uncertainty, our approach focuses on companies with strong market positions and high levels of profitability. We naturally tend to avoid companies with high levels of leverage, or interest expense burdens, as these are incremental constraints to diminish profits and create refinancing risk. At this point of the economic cycle, we favor quality and profitability metrics over more cyclical factors. Should the economy falter, stable earnings, high margins, and growth opportunities tend to weather uncertainty while still providing opportunity in rising markets. We also continue to prefer those sectors with secular trends and companies with shareholder-friendly practices.

Thank you for your investment in the Oak Associates Funds.

With regards,

Robert Stimpson, CFA
Co-Chief Investment Officer & Portfolio Manager
Oak Associates Funds

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