

thoughts

FROM HANSON+DOREMUS



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The adaptable class of 2024...

Over the last month, universities and colleges across the U.S. bid farewell to the Class of 2024. Much has been written about their character, but an underappreciated observation might be this: the Class of 2024 has proven its adaptability and resilience.

With the advent of COVID-19 and related lockdowns, members of the Class of 2024 were forced to finish high school remotely. They missed out on prom and walking across the stage to receive their diplomas in a traditional graduation. They also started college remotely, taking classes online from home or alone in a dorm room instead of flooding onto campus to meet new friends and embark on a new journey. Beyond the pandemic were social issues, economic worries, and armed conflicts around the world that cast shadows across campuses as this class

moved towards college graduation. Despite widespread media coverage of contentious demonstrations over Gaza and cancelled graduations, most campuses saw only peaceful protests, allowing most members of the Class of 2024 to finally enjoy the full graduation experience.

What world awaits these graduates? While the overall economy is doing well, the combination of inflation and slower tech hiring means the Class of 2024 is facing a slightly tougher job market than recent graduates. The job market remains more robust than the one col-

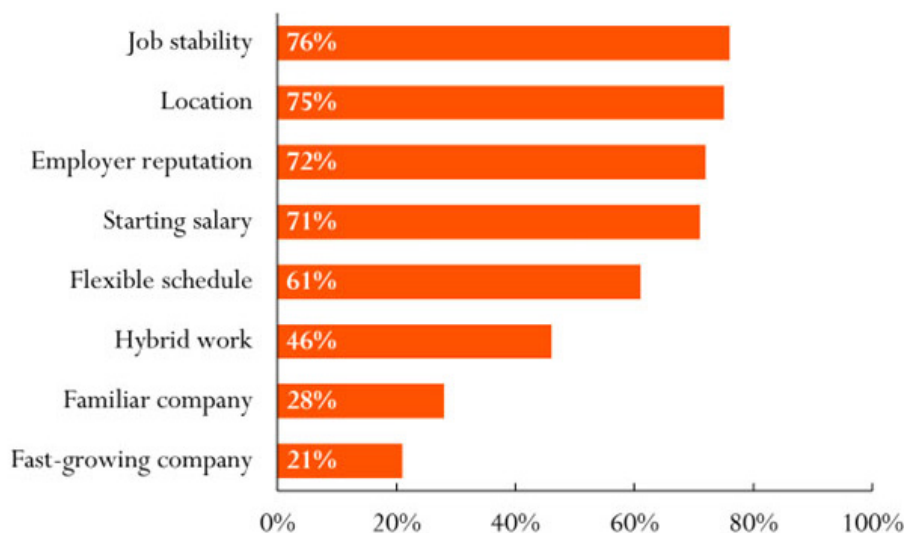
lege graduates faced 15 years ago. But even with a relatively strong market, one third of 2024 college grads surveyed by iCIMS, a recruitment software company, were contemplating part-time work. A survey from the job platform Handshake found a similar percentage looking to add freelance or gig work to a full-time job to cover the high cost of rent and student loans. Tellingly, an overwhelming 76% of the grads value job security more than other factors, according to the Handshake survey (see chart below). That's hardly surprising given the instability they have faced over the last five years.

Many members of the class want to start in the office, as face-to-face interaction is viewed as both a reminder of pre-pandemic normalcy and an important part of joining a new team. But flexibility remains an important factor with 61% of Handshake survey respondents more likely to apply to a job offering a flexible schedule.

The Class of 2024 often gets tagged as being more fragile and less driven than previous graduates, but it's looking like they may be more nimble. The crisis and challenges of the last five years may have made recent graduates more resilient and adaptable than they could have imagined.

- Neil Macker

THE CLASS OF '24 IS MORE LIKELY TO APPLY BASED ON...



Source: Handshake



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Investing themes come and go...

In last month's issue, we examined the concept of economic "moats" and how we use them to help identify and value potential portfolio investments. While the term is not new, its popularity has grown over the years. Investors' love affair with companies possessing wide moats, or durable competitive advantages, comes as no surprise given results in the table below. Morningstar's Wide Moat Index has outperformed the S&P 500 index over the past 1-, 3-, 5- and 10-year periods.

With over 35 years of investing experience under my belt, I am left wondering, is the focus on wide moats today just another investment fad? *The chart to the right*, identifies the investment themes that dominated each of the past seven decades. Speculative behavior certainly fueled the outsized gains in each period, but other more fundamental factors also played an important role. Here are a few of them.

The Economy Matters: Over long periods of time, stock prices move in lock step with corporate profits. Given this dynamic, it comes as no surprise that strong economic forces were at work during several of the decades. In the 1950s, an influx of corporate and government funds into post-recovery Europe benefited firms across the region. In the 1960s, an emerging consumer class (i.e., Baby Boomers) fueled gains in the Nifty-Fifty, a group of stocks dominated by firms like Polaroid, McDonalds, and Disney. Economic policies aimed at boosting industrial production and export trade contributed to Japan's "economic miracle" in the 1980s.

Commodity Booms (and Busts) Happen: Commodity price cycles have historically had a big impact on emerging market stock performance. This was especially true in the 1970s when spiking energy prices fueled gains

WIDE MOAT STOCKS OUTPERFORM

As of 5/31/24, Average Annual Total Return (%)

	Wide Moat Composite	S&P 500
1 Year	31.8	26.2
3 Year	10.5	9.3
5 Year	16.7	15.4
10 Year	14.1	12.0

Source: Hanson & Doremus, Bloomberg, Morningstar

INVESTMENT THEMES BY DECADE



Source: NSC Advisor.com; Morgan Stanley Investment Management

in the shares of oil and gold exporters. While most emerging market economies have diversified and matured since then, strong commodity price rallies again featured in the more recent (2000-2010) period of outperformance.

Keep an eye on Technology: Both the 1990s and the 2010s were periods dominated by technological innovation. The promise of all things connected to the World Wide Web led to the surge and subsequent bust of tech stocks during the 1990s. While a whole range of tech stocks did not survive the period, many firms from the era, such as Cisco and Amazon, remain vibrant today. The adoption of a range of technologies in the 2010-2020 period led to the FAANG tech stock surge.

What stocks or themes are likely to dominate going forward? It would be easy to assume that the 2020s will go down as the "Artificial Intelligence" decade. But despite their strong outperformance over the past year, I have doubts. As a technology, AI holds great promise and yes, not a few risks. But historically, the process of figuring out how to make money off a new technology takes time.

Because of their durable competitive

advantages, I continue to think that wide moats stocks will produce above market returns over the long term. But I doubt the group, as a whole, will generate the eye-popping returns witnessed in "theme" stocks of earlier decades. For one, the wide moat concept lacks the simple and appealing narrative typically found in earlier thematic investments. Second, wide moat stocks are a large and diverse group. Morningstar's index, which makes up approximately 65% of the S&P 500's market capitalization, includes 157 holdings from many market sectors. This broad diversity suggests that any rally in the shares would also be largely reflected in broad market indices like the S&P 500, limiting outperformance.

Whatever comes next, this look-back in history has revealed a few things. First, assuming that last decade's winners will dominate in the next cycle has not proven to be a profitable strategy. Second, predicting which sector or asset class will dominate next is extremely difficult. Our approach of trying to pay reasonable prices for firms that possess durable competitive advantages across market cycles helps protect us from both of these market truths.

We're not (just) in Taiwan anymore...

Taiwan Semiconductor Manufacturing Company, or TSMC, the world's largest contract maker of semiconductors, has long exercised world domination in the manufacture of leading-edge chips from the small island of Taiwan. Only in recent years -- as geopolitical rivalry has intensified -- has TSMC started venturing beyond Taiwan and its two lesser facilities in mainland China. Whether it can transfer its world-beating ways beyond its borders -- to Japan, Germany, and the U.S. -- is yet to be seen. But at least in its early days in Arizona, stepping out of Taiwan hasn't been easy.

When TSMC first announced it would invest \$12 billion into a new fab (semiconductor fabricating facility) outside of Phoenix in 2020, it was very welcome news for the U.S., which has been vigorously pushing to bring more chip manufacturing back onshore. It also was good news when TSMC increased its commitment to \$40 billion and a second fab in 2022 -- and then in April of this year to \$65 billion and a third fab, thanks to funding from the CHIPS and Science Act.

But along the way, there have been stumbles and delays. Construction in the U.S. is slower and more expensive than in Taiwan. TSMC had to push the opening of its first Arizona fab from 2024 to 2025 -- and for the second fab from 2026 to 2028. In an early 2023 call with investors, TSMC noted "some challenges in obtaining permits." The next quarter, it highlighted a much larger problem -- "an insufficient amount of skilled workers with the specialized expertise required for equipment installation in a semiconductor-grade facility." TSMC's solution was to send experienced technicians from Taiwan to Arizona. At the same time, it ramped up hiring in the U.S. and sent many of its newly hired American employees to Taiwan for training and acculturation.

While things in Arizona have turned more positive recently, it's been widely reported that getting the Americans and Taiwanese on the same page was a struggle. An article by Viola Chou called "TSMC's debacle in the American desert" describes cultural breakdowns on both sides. The Taiwanese complained the Americans didn't work hard enough. The American engineers found it difficult to do so when crucial meetings and documents were only in Mandarin or Taiwan-



TSMC's Arizona site under construction

Source: TSMC

ese. The Americans had to learn it wasn't customary to ask or try to understand why they were doing what they were asked to do -- but to just do it. The Taiwanese had to learn that "Americans responded better to encouragement rather than criticism." According to Chou's story, when an American asked a Taiwanese manager what the top priority was, the answer was always, "Everything is a priority."

These cultural rifts would come as no surprise to Morris Chang, who founded TSMC in 1987 after spending decades in the U.S. at Texas Instruments. In a 2021 talk, Chang said, "Computers of different brands can often be hooked together, but not people of different culture." He also said, "The fact that TSMC's top-flight executives can deliver top results in Taiwan is no guarantee of similar performance when they are posted overseas."

Chang has always been doubtful of the U.S. succeeding at chip manufacturing -- because of higher costs, skills deficits, and a work ethic that frankly falls short of Taiwan's. "If a piece of equipment breaks down at one o'clock in the morning," he once said, "then in the U.S., it will be fixed by nine. In Taiwan, however,

it will be fixed at two a.m."

It's hard not to compare Arizona with TSMC's experience in Japan, where it opened a new fab in Kumamoto earlier this year on time and without a hitch. And you may or may not agree with what Morris Chang says about cultural differences between the U.S. and Taiwan. But it's hard to disagree that some part of TSMC's success comes from a finely tuned ecosystem in Taiwan that has developed over decades. Taiwan is a small island with an efficient high-speed rail system. TSMC's well-established connections between headquarters in Hsinchu and plants in Taichung and Tainan mean engineers and resources can easily be shifted among sites. TSMC also has had decades of experience managing tightly integrated, complex relationships with suppliers and customers -- not something that's easy to replicate. Just ask China, which has poured billions into developing a domestic industry but found that money is not enough to get to the leading edge. Or ask struggling Intel. As NVIDIA's founder Jensen Huang once said, over the years TSMC has learned to dance with 400 partners while Intel has always danced alone.

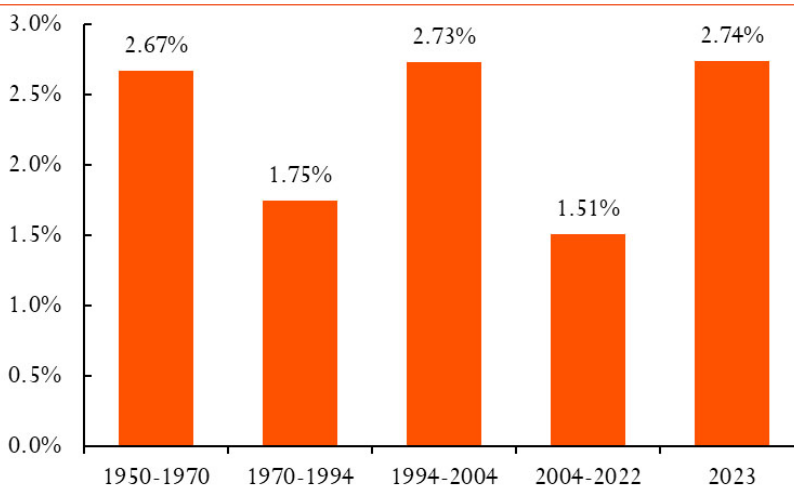
Economic growth for dummies...

No – nobody is dumb here. We are just trying to simplify the complex U.S. economy. Real economic growth (growth after taking out inflation) is what drives hiring and corporate profits, allows for wage increases, and spurs the stock market. It’s important. So an obvious question is, what drives economic growth?

It is a function of just two factors (here comes the simplification): growth in population/labor force and growth in productivity (the increase in what a worker can produce in an hour). If you have more people working and they are producing more per hour, you will get a growing economy. In the past (more simplification here), in the U.S., you could generally count on 1% per year growth in population/labor force and a 2% per year increase in productivity, giving us the historic longer-term 3% annual economic growth rate.

Now comes the problem. Population and productivity are no longer growing at their historic rates. Across the globe women are having fewer children. Jesus Fernandez-Villaverde, an economist specializing in demographics at the University of Pennsylvania, estimates that the worldwide fertility rate (the number of children women expect to have) fell below the replacement level of roughly 2.1 last year for the first time in history. It’s happening in the U.S. too. After holding fairly steady at 2.0 for a number of years, the U.S.

AVERAGE PERCENTAGE CHANGE IN WORKER OUTPUT PER HOUR



Source: Bureau of Labor Statistics, The Aspen Institute Economic Strategy Group

fertility rate fell to 1.63 last year.

Population and the size of labor force is also affected by immigration. There are 32 million documented foreign-born people working here and another estimated 10 million undocumented. The U.S. is blessed, or cursed according to some, with plenty of immigration demand. People want to come here. We could offset our lower birth rate with increased

immigration. But this debate goes well beyond economics. It is fraught with politics. No easy answers from us.

Productivity is harder to predict than population. It can blow hot or cold for extended periods (*see chart in the upper right*). The good news is that after two decades of poor performance, productivity in the U.S. is rising again. The optimists say AI and a dramatic increase in new business formations post-Covid will fuel long-term improvement. The pessimists fear that high inflation and high interest rates, along with unpredictable domestic policies, will cut short the recent productivity gains.

Higher productivity and overall economic growth is important, not only for jobs and wage increases, but also for dealing with the high interest payments on our national debt and for funding the increasing demands on Social Security and Medicare. Root for labor force growth and productivity.

TOTAL FERTILITY RATES



Source: United Nations; U.S. Centers for Disease Control; national estimates compiled by Jesús Fernández-Villaverde; graphic by Rosie Ettenheim, *The Wall Street Journal*

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