SANDHILL
INVESTMENT MANAGEMENT

January 3, 2023

Dear stakeholders-

After a difficult start to the year, Sandhill returned to form.

We had a terrific year.

We beat our benchmarks for every product in a difficult and complex year.

We did a great job protecting our clients' capital.

While no one gets excited about losing money, I do not believe that we have handed any of our clients permanent capital loss.

One of the most important parts of our job is to protect and preserve capital in bear markets. Numerous bubbles burst in 2022, and our clients were caught in none of them.

Our flagship **Concentrated Equity Alpha** (CEA) composite returned -16.9% net of fees for 2022. The Russell 3000 Total Return Index returned -19.2%.

The most impressive part of the CEA's performance is that it is a **growth product** and beat the broader market whose return was driven by value stocks. Growth outperforms value over time and capital flows will return to growth when the Fed is done raising interest rates.

Our **Corporate Bond** composite returned -7.1% net of fees for 2022. The Bank of America Merrill Lynch 3-5 Year Corporate Bond Index returned -8.2%. The Bloomberg US Aggregate Bond Index returned -13.0%. The thirty year U.S. Treasury Bond returned -35.8%.

Sandhill's bond performance relative to the broader bond market was really good for two reasons. First, we stayed **short on the yield curve** which left us less exposed to the numerous interest rate increases from the Fed. Second, we were rock solid on credit quality.

The short duration of our bond portfolios will allow our clients to cycle out of the majority of their lower yield to maturity bond investments over the next few years and redeploy their bond capital at better rates of return. In the meantime, and investors forget this, the cash flow keeps coming every quarter with their current bond portfolios. The mark to market losses on our current bond portfolios will lessen as the bonds get closer and closer to maturity. Expect some good bond returns in 2024 and 2025. Stay patient.

Our **Large Cap Yield** (LCY) composite returned -8.2% for 2022. The Dow Jones Industrial Average returned -8.8%. The Large Cap Yield product is a more conservative product. The Large Cap Yield companies are larger capitalization companies that tend to have lower valuations and higher yields than the companies in our CEA (growth) product. The Large Cap Yield portfolios were well managed and the place to be in 2022.

The **Private REIT** product that Sandhill distributes and monitors like any of our other holdings returned +7.9% in 2022. Sandhill's clients in aggregate make Sandhill the largest investor in the REIT. With the rapid and large increases in interest rates in 2022, the REIT will be challenged financially in 2023. We do not expect the REIT to decrease its dividend, but it will likely have to pay out 110% of its Funds From Operations (FFO) in 2023 to cover the current dividend. This will not be sustainable over a long period of time. Rent increases and purchasing new properties at higher capitalization rates should allow the company to recalibrate and get back on track over the course of 2023. For the moment, I would not commit new capital here.

Outlook for 2023

I do not think the bear market is over.

Most bear markets end with a capitulation – we have not had one.

The **popular line of thinking** now is the interest rate increases of 2022 will cause a mild recession, the Fed will stop raising rates and even cut rates, and the stock market will be off to the races.

I disagree.

I believe that our economy is much stronger than people think and the labor market will remain tight, unemployment will remain low, wage inflation will moderate but still be a problem, and **the Fed will have to raise rates more than anticipated**. At that point, the stock market will crack.

And that will be the point of maximum opportunity.

How Sandhill is positioned

Sandhill is well positioned. We are dealing from a position of strength and ahead of the curve.

We just need to be patient.

Our CEA portfolios have been cleaned up and look great. Companies with levered balance sheets or not operating well have been sold. We own high quality growth companies at attractive prices. The growth bubble that burst in 2022 allowed us to buy the highest quality growth companies at good valuations. Better yet, we still have a 9.6% cash position to deploy as opportunity presents.

New Product

Sandhill released our new **Preferred Stock** product in November. Very excited about it. A preferred stock is a complex instrument that is really a hybrid security with both stock and bond characteristics.

With the substantial rise in interest rates in 2022, there are currently attractive income producing investments (with capital appreciation potential) open to investors that were not available a year ago. Further, I am not sure how long the window will be open.

The Preferred Stock product is a basket of fourteen preferred stocks that all have qualified dividends – meaning that they are taxed at the 20% federal rate – a huge advantage to taxable bonds for those in high income tax brackets. We are currently able to buy all the securities in our portfolio at a discount to their issue and call price. The current yield on the product is 5.3%, the yield to perpetuity is 7.5% per annum (theoretical return), and the yield to call is 8.8% per annum (theoretical return). This is an actively managed product as securities in the portfolio will be called from time to time (which we want). I do not want to give too much more away publicly – if you are interested in the product, please talk to your advisor.

We now have three great products in the fixed income asset class – our corporate bond portfolio, the Private REIT, and now the Preferred Stock product (which we consider a bond proxy with equity characteristics). More important, I think that each product is better situated for success in different rate environments – so **our clients can work with their advisors to choose the best fixed income product for the current interest rate environment at the time of purchase**. We have briefed our advisors on which product is best in what rate environment.

Assets under management

Sandhill's assets under management and advisement at year end 2022 were $1.83 billion. Assets under management declined $431 million in 2022 because of the stock and bond markets decline and net asset outflows (mostly at the beginning of the year).

Going forward

We really had a good year in 2022. What I am most proud of is we were up against it and responded. The investment team gets high marks for adapting and executing in a really difficult environment and putting our clients in a really good position going forward. We returned to capital discipline, rigor, and patience in 2022 and it served our clients well. Expect more of the same in 2023.

I expect a bumpy and maybe even difficult first half of the year, a bear market bottom in 2023, and a steadying interest rate environment after a few more rate increases from the Fed. We may have a mild recession, but this does not worry me.

In this highly problematic world, full of so many wonderful things and so many horrors, the United States capital markets remain far and away the best place to deploy capital with safety and transparency to earn a rate of return to keep pace with or exceed inflation, reach your financial goals, and hopefully give back along the way.

Happy New Year!

With warm regards,

Edwin M. "Tim" Johnston III
Founder, Co-Managing Partner

Annualized Performance Summary (Net of Fees)

As of 12/31/2022	CEA (Master)	Russell 3000 TR	Corp. Bond	B of A ML 3-5 Year	Large Cap Yield	DJIA
1 Year	-16.9%	-19.2%	-7.1%	-8.2%	-8.2%	-8.8%
5 Year	6.0%	8.8%	1.1%	1.4%	6.7%	6.0%
10 Year	12.0%	12.1%	2.3%	2.0%	9.1%	9.7%