ALTMAN
INVESTMENT MANAGEMENT

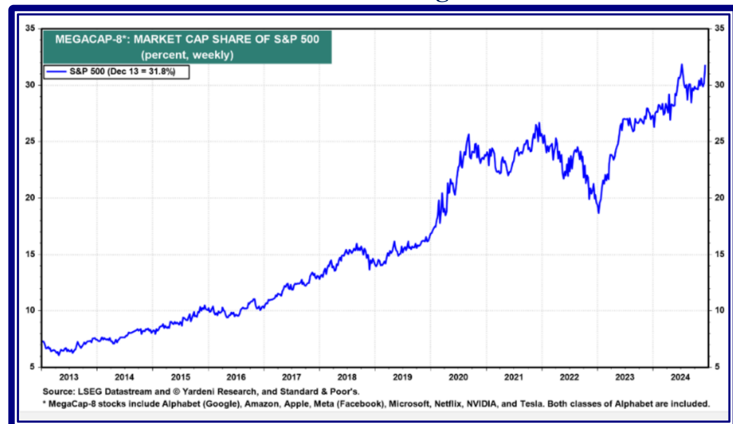
EQUITY STRATEGY FOCUS

JANUARY, 2025

IN VIEW: 2024 Portfolio and Market Performance

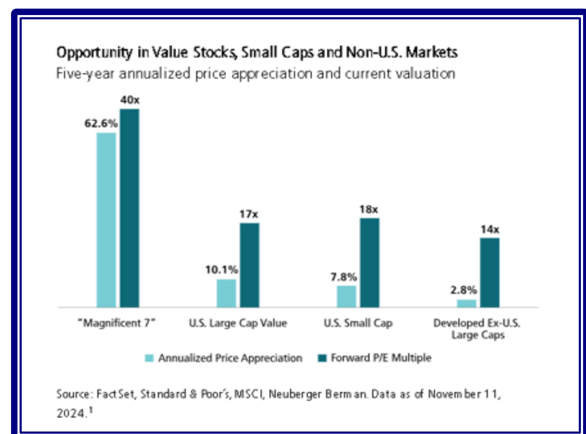
We are witnessing one of the narrowest markets in over 30 years, only surpassed by the final years of the technology bubble. The Mega 8 stocks (Nvidia, Apple, Amazon, Meta, Microsoft, Google, Tesla and Netflix) continue to have a disproportionate impact on the benchmark S&P 500 index. Specifically, these stocks account for 55% of the market return this year. The S&P 500 index returned 25% for 2024, but excluding the Mega 8s, the S&P 500 index was up only 11.2%. Although it is widely recognized that narrow markets imply significant risks, speculators are flooding the marketplace and lifting valuations in these few select stocks (the Mega 8s) to what we believe to be unsustainable levels. Richard Bernstein Associates calculates the equity beta (a measure of volatility) of private client accounts has now reached 1.45 as compared to only 0.75 at the beginning of the bull market. That statistic demonstrates that investors are putting risk assessment aside in order to chase exorbitant market gains.

Mega 8 Stocks Market Cap % of S&P 500 at All Time High



We continue to see spurts of a broadening in the market as we did in Q3 with the Russell 1000 Value outpacing the S&P benchmark by over 354 basis points. The indices then traded in sync up until the election, when a Republican sweep lifted markets to all-time highs. Pro-growth policies favoring lower taxes, protectionism, and deregulation are fueling investor optimism back towards significantly high earnings expectations without regard for sustainability.

A chart from Neuberger Berman illustrates the opportunity evident within the value spectrum given significant multiple expansion within a narrow sector of the marketplace. **<u>Sustainability is key.</u>** Often times of exuberance and speculation portend a change in market leadership. Value stocks are ripe for the taking, particularly since most of the earnings expectations and high margins are already priced into today's leading stocks. Any deviance from expectations opens these stocks up to extreme vulnerability and favors stocks with strong fundamentals and below average multiples.



Capex by hyper-scalers continues to climb and is expected to dominate capex spend for the S&P 500 in aggregate. While capex spend is a driver for AI, a longer-term question exists as to how and when this spend can be monetized. The payoff from such efforts is complex due to difficulties in monitoring customer usage of AI tools and transitioning that into a billable product. Additionally, capex spend can be a headwind at such significant levels, as a study by BofA Global Research shows capex growers tend to underperform historically against the equally weighted S&P index.

According to FactSet, analysts are expecting a year-over-year growth rate in earnings of 9.5% for 2024. This tops the 10-year average growth rate of 8%. Inflating the 2024 estimate is the 33% expected growth rate in earnings for the Magnificent 7 stocks (Mega 8 excluding Netflix). Looking ahead, analysts are calling for a growth in EPS (earnings per share) of 15% for 2025. Yet, speculation in the market appears to be ignoring overall economic strength - and thus expectations for broader earnings growth remains underappreciated.

The stock market averaged just under 14% per annum over the past 15 years. This surpasses the long-term historical average of approximately 10% for the S&P 500 index, but falls short of the 18% annualized return during the decade that encapsulated the technology bubble. At the peak of the technology bubble, the technology sectors represented 32% of the S&P 500. The decade that followed was known as the lost decade in equities, when the average annual return for stocks was just under -1% per year. Today's narrow stock market representation has also reached the 32% level. Going forward, we expect returns will be closer to historical levels as investor sentiment shifts in favor of growth at reasonable prices.

The AIM composite surpassed the CPI during 2024 by over 400 basis points for a return of 6.8%/6.1% (gross/net on a discounted cash flow basis). The overall market enjoyed spurts of broadening throughout the year, although the final quarter was underwhelming. The S&P 500 returned 2.42%, with investors once again flocking into the Mega 8s. Excluding these stocks, the benchmark came in -0.74% for Q4. The Russell 1000 Value index traded down 2% and the AIM composite fell -3.3% and -3.5% gross/net on a discounted cash flow basis. While our relative performance can be discouraging to some, it is imperative to consider the results within the scope of our objective which is to achieve long term performance with below average risk.

There are several specific stocks that are responsible for some short-term dispersion against the Russell 1000 Value index, which produced a total return of 14.4% during the past year. Within the Russell index, JP Morgan, Berkshire Hathaway, and Walmart contributed 263 basis points of out-performance, alongside Dollar Tree, Intel, Archer Daniels Midland, Occidental Petroleum, Conoco Phillips, and Baxter which detracted 475 basis points from relative performance. We have already taken steps to address this disparity. Although it is not preferred, temporary relative underperformance is a fact of "investment life", the goal however being to harness a complete understanding of disparities and maintain discipline so as to stay true to the stated long-term investment style and investment process.

Warren Buffet, Chairman and CEO of Berkshire Hathaway, is known to be one of the greatest investors of all time. But even the Oracle of Omaha has not escaped periods of investment woes. The 2010s decade was an example of such relative underperformance. Not only was the growth investment style outperforming value, but Warren Buffet made some unfortunate investments in Kraft Heinz and IBM. Additionally, his allegiance to his investment strategy of not overpaying for companies prevented him from making several more accretive acquisitions.The portfolio therefore was carrying a significant portion of cash during a time when other investors were willing to pay up for long term growth prospects. This caused the portfolio to underperform against the S&P 500 index for over a decade. By the end of 2020, Berkshire Hathaway's performance lagged the index by approximately -6900 on a cumulative total return basis. More importantly though is that the long-term annualized performance during that time did not stray far from the benchmark.

Even Berkshire Hathaway Under-Performed the S&P 500 for Over a Decade

Range 12/31/2009 - 12/31/2020 Period Daily No. of Period 4018 Day(s)

	Security	Currency	Price Change	Total Return	Difference	Annual Eq
1)	BRK/B US Equity	USD	252.81%	252.81%	2.20%	12.13%
2)	BRK/A US Equity	USD	250.62%	250.62%	--	12.07%
3)	SPX Index	USD	236.84%	321.80%	71.18%	13.97%

In fact, more recently, Berkshire Hathaway has outperformed in 3 of the last 4 years, narrowing the gap significantly against the S&P 500 on a cumulative basis. The long-term annualized return is now 13.7% vs 13.9% for the index. This lesson is underscored in a quote by Warren Buffet himself when he said "We don't have to be smarter than the rest. We have to be more disciplined than the rest."

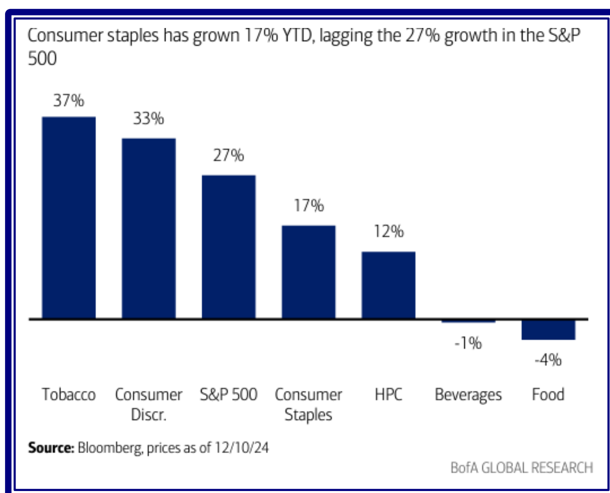
CLOSE-UP: Equity Sector Overview

Our current constructive economic stance implies that the overall earnings outlook remains positive, favoring a broadening out of market participants. S&P 500 companies delivered solid earnings in the third quarter, with a healthy number of index members beating top- and bottom-line estimates. Corporate profits are supported by robust revenue growth reflecting the ongoing strength of the economy. Communication Services and Technology topped the list of sectors with the best earnings growth, while the Energy, Materials, and Industrial sectors saw their profits contract. Earnings growth and valuations for the market in its entirety are underappreciated relative to a few select mega cap stocks. It is likely we will see sector rotation towards more cyclical segments in the new year, particularly as the growth rate expectations of the Mega 8s are unsustainable.

In the fourth quarter, we established a position in Keurig Dr. Pepper, added to Baxter (BAX), sold Dollar Tree (DLTR) and Archer Daniels (ADM), and trimmed our position in Oracle (ORCL). This in effect, reduced our exposure in Technology and Consumer Staples, and increased our exposure in Health Care. Sector positioning in our composite continues to overweight Financials, Industrials, Health Care and Energy. We are underweight Information Technology, Communication Services, Utilities, Real Estate, and Consumer Discretionary sectors.

Keurig Dr. Pepper (KDP) is a U.S. based leading hot and cold beverage provider specializing in carbonated drinks and specialty coffees. KDP recently announced a deal to purchase energy drink and sport nutrition brand GHOST, one of the fastest growing brands in the energy category. This acquisition expands KDP's energy segment client base that has grown in popularity over the years along with the demand for fitness and lifestyle products. KDP is continuing to enhance distribution capabilities and has a growing list of preferred partners to provide total solutions across its range of products, improving overall scale and efficiencies. KDP has been working to improve upon its K-cup dispensers to lower costs and improve its environmental impact. Additionally, as global awareness for health and fitness thrives, the trend is likely to favor non-alcoholic beverages. On a relative basis, KDP trades at a 35% discount to the S&P 500 index on a trailing 12-month P/E basis. The discount to the beverage industry and the consumer staples industry as a whole is 13% and 20% respectively. Throughout the last year, the beverage industry has underperformed relative to other sub-industries signaling significant upside potential.

Stock Price Performance by Relative Sectors & Industries



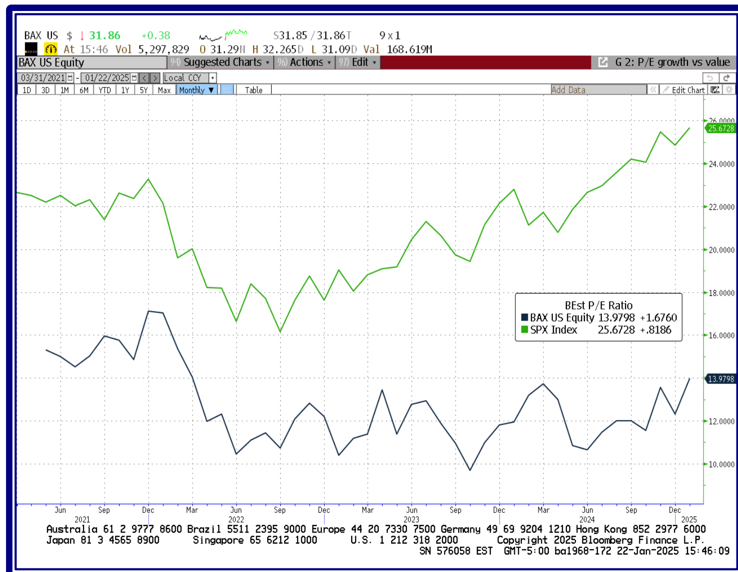
Dollar Tree (DLTR) continues to experience pressures from declining sales, as wage growth amongst the lower income bracket slows significantly. As reported by Bloomberg and HSA Consulting, headline inflation understates the actual price hikes on lower income households based upon their specific consumption basket. In other words, price hikes have been more pronounced in need-based categories as opposed to more discretionary items. Its strategic initiative for multiple price levels is hitting some resistance and adding to competitive pressures. Recent executive turnover also added to strategic uncertainty.

Archer Daniels Midland's (ADM) lingering accounting irregularities have created an overhang that appears to be ongoing. Oversupplies of ethanol is adding to short term challenges. Chinese demand could be at risk given aggressive policies of the incoming administration towards foreign trade, China in particular. Management cuts its full year guidance on inflationary pressures in the nutrition segment, global regulatory uncertainty, and operational changes. Continued restatements and a delay in Q3 earnings call did not help to clear up any uncertainties surrounding the stock.

Baxter International Inc. (BAX)

Post election healthcare policy uncertainties led to relative underperformance within the healthcare sector during the 4th quarter. At a forward price to earnings ratio of 12.7x, shares of BAX appear undervalued and provide upside opportunity. 8 of its 10 manufacturing lines in North Carolina that were damaged during Hurricane Helene have been restarted. The company expects the ramp up of these lines to reach pre-hurricane operating levels within the first quarter, albeit with some short-term delay in product flow through. To help support inventories in the interim, BAX has activated numerous plants within its global network. Demand is improving for its infusion pump, and management is focused on growth and expanding margins. The company's ability to develop patented differentiated products coupled with lengthening switching costs is key to maintaining its competitive edge. As part of BAX's ongoing business transformation in pursuit of maximizing shareholder value, the company is moving forward with its planned divestiture of its kidney care unit. Proceeds from the sale are intended to go towards debt reduction efforts. The remaining medical supply segments have been under pressure due to inflationary pressures stemming from the pandemic. Inflation has cooled off its 2022 peak and should provide some relief. Continued innovation, the difficult nature of new entrants, and growth from emerging markets are long term drivers of the stock. The shares are currently trading at a substantial discount to their historic multiple range. Assuming the company can resume a 5% earnings growth rate in 2025, we are expecting the multiple on the shares to expand back to 15 times the trendline earnings.

Baxter Presents a Buying Opportunity



Large Cap Banks - Preliminary Overview:

The fourth Quarter earnings reports for the banks were very strong for the Large Cap Banks, driven by healthy capital markets revenues, strong trading results and a steepening yield curve. We are expecting more earnings surprises in quarters ahead, with the capital markets recovery just getting started and regulatory stabilization expected.

Investment Banking activity in general accelerated better than 38% year over year with overall revenues from equity capital markets by the money center banks increasing by an aggregate 78% y/y, and Merger and Acquisition up by 20% y/y. Debt capital markets also showed a very strong year over year comparison increasing as much as 41%, according to Morgan Stanley research. However, we still believe we are in the early innings expecting further acceleration. The fourth quarter annualized activity is still running behind the 3-decade average results relative to nominal GDP. Keep in mind that M&A activity is running 44% below 1996-2004 annual averages, but we expect a return to the historical averages in 2025, and potentially overshooting the average in 2026, in line with prior cycles.

Recent conference calls by management in early January pointed to pipelines increasing - and confidence is expected to continue to build post-election. Overall capital markets revenues are accelerating, up 24% y/y. Trading activity is also accelerating, supported by high volumes following the U.S. election and strong equity/debt issuance. We believe banks can continue to grow their trading profits through 2025 on a y/y basis, supported by equity market capitalization. Investment Banking-related activity was also very strong, and a steeper yield curve drove net investment income expectations by a full percentage point in the quarter, as well as 2025 NII guidance well above expectations. Large Cap Banks are currently in a strong financial position.

Given an improving earnings outlook with less regulatory uncertainty, we expect banks will at least keep capital-at-risk ratios flat in 2025 and buy back their earnings less dividends. We continue to overweight the sector in portfolios. We believe that we are still in the early stages of a capital markets recovery that should drive PE multiples higher along with upwards earnings revisions that support the next leg of outperformance.

SUMMARY:

We anticipate a more consistent broadening in the marketplace that levels out the extreme concentration currently in the market. We continue to emphasize that valuations matter in the long run. Market leadership will eventually expand beyond the AI dominant areas into underappreciated sectors with the potential for earnings growth. Therefore, it is prudent to continue to de-emphasize this narrow group of expensive mega cap stocks. At a combined forward price to earnings multiple of 30.9x for these few stocks, concern over their sustainability is real. A focus on fundamentals is imperative in order to retain stock market profits. Therefore, we continue to emphasize banking to capitalize on improving interest rate spreads, healthcare for free cash flows, and energy for yield.

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Any performance reference represents a hypothetical composite compiled from actual equity, fixed income or balanced client portfolios and includes cash. These three composites reflect aggregated returns that address differing objectives. As such, the performance of each composite does not reflect the actual total portfolio returns earned by our clients. The investment performance records are compiled from a capital weighted average of the equity, bond and cash components of a broadly representative group of discretionary accounts that meet certain minimum size thresholds.

No gross performance returns that are referenced that are calculated after brokerage commissions but before investment counsel fees are presented without the comparable net performance figures after both commissions, investment counseling fees and other custodial charges. The net counseling fees are the actual average counseling fee calculated across all the portfolios included in the composite. All performance figures are presented on a time-weighted total return basis and assume all income is reinvested. The investment advisory fees are disclosed in Part II-A of the Investment Form ADV. Some clients may benefit from available discounting in the management fee schedule associated with the overall size of the portfolio. Management fees will reduce overall returns to the client.

The composites were created in 2001 and the inception dates start on August 17th, 2001.The composites include only discretionary fee-paying accounts managed in the strategies, and additional information associated with the composites are available such as: dispersion in individual portfolio results as well as the % of the firms AUM in the strategy. All performance calculations are presented within the GIPS® guidelines of the CFA Institute. The CFA institute does not endorse or promote this organization nor does it warrant the accuracy of the content herein.

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