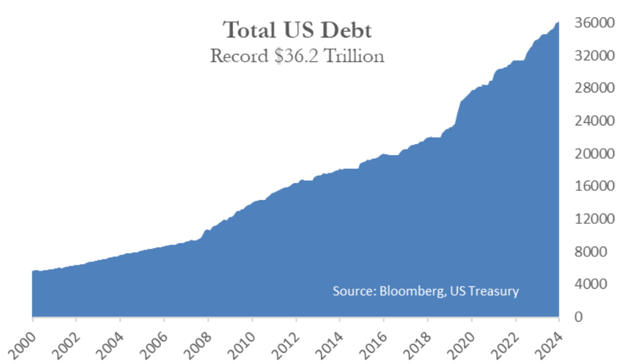
4Q2024

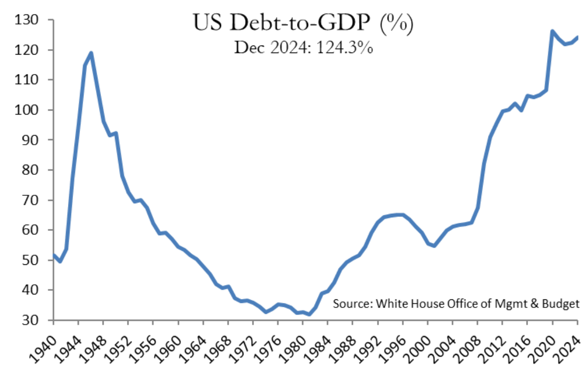
The art of living is more like wrestling than dancing.
--Marcus Aurelius

The end of every year is such an insightful time. It triggers in each of us the desire to self-reflect on our actions during the past twelve months and consider how we may improve in the New Year ahead. Then, after about two weeks, it's back to business as usual. Sit-ups, sobriety, and an overly positive attitude are hard to maintain and eventually fade back to the normal routine of our lives. It was the respected educator, Dean Wormer, who once eloquently stated, "Fat, drunk, and stupid is no way to go through life, son." It takes commitment and persistence to improve, and the results aren't always immediate. The struggle is part of the journey.

Yet to many in the investing community, any commitment to process and discipline has eroded away to a focus on growth at any price, leverage, and an expectation that returns will automatically follow. There is no denying that 2024 by most estimates was a banner year for equity investors. My own expectations at the start of this past year, as you know, were for more muted results and a much more realistic emphasis on the fundamentals of each business we follow. The lesson learned, however, is that the mighty hand of government spending can prove to be a powerful force when unrestrained by common sense and mathematical eventualities.

The US Treasury ended 2024 with a total public debt balance of $36.2 trillion (a new record!) and a new incoming president-elect in Donald J. Trump. The people spoke at the ballot box and opted for change. The promises of a new future have been grand in scope but light on details. In the days following the election, equity investors witnessed a year's worth of returns based on hope for the future and relief related to a quick and clear decision at the polls. Unfortunately, nearly half of November's gains were returned in December as the realities of the path forward and repositioning into year-end took hold. The incoming administration made two grand economic promises during the election process: to boost economic growth and to end inflation. Is it possible to do both concurrently?





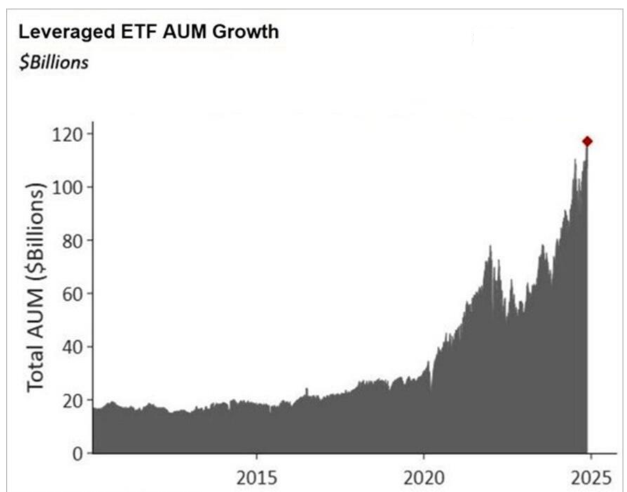
Or is Trump the next Ronald Reagan? Unlike today, in 1981 President Reagan was faced with 9% inflation and over 10% unemployment. One similar characteristic to the current economy, however, was a worrisome level of deficit spending. Reagan enacted tighter monetary policy to tame higher prices and consciously drove the US economy into a painful recession that lasted nearly 18 months. At the time, it was the worst economic downturn since the Great Depression. Many seasoned investors remember this period as a very painful time. The Reagan administration cut government spending and slashed regulations. These actions and the sharp economic contraction reset the economy and markets back to a level where growth could begin to build a new and prices became much more rational. Like most leaders, however, President Trump has historically embraced lower interest rates to drive national output. Lower rates create conditions for credit expansion while also adding to the money supply domestically, which promotes higher spending. The dilemma here is that more borrowing and higher spending is inherently inflationary. Couple that with a much more restrictive trade policy and it isn't hard to envision a scenario where price inflation moves back to the forefront of economic issues.

Compounding the inflation concern is a Federal Reserve that has opted to lower interest rates by 1.00% in the final four months of 2024 despite a seemingly robust economic backdrop. The shift in policy, as we discussed in our last letter, began with a shocking 50bps decline at their September meeting as they "reset" the Fed's policy. No doubt a completely "apolitical" maneuver that still yielded no results at the polls for the sitting Party in control. Surprisingly, the Fed continued to lower interest rates in the November and December meetings despite inflation levels persistently above their target of 2%. The relationship between the President and the Fed Chair will be one worth watching as we progress in 2025. Any shift in policy or any volatility in markets will likely result in a game of blame. Let's hope for a smooth and amicable relationship.

Has the value of American "exceptionalism" run too far? The exceptionalism I'm referring to has nothing to do with politics, diplomacy, or military prowess. Rather it refers to US financial markets and their ability to consistently outperform all other global markets because of the earnings power of America's top companies, their global reach, and their leading role in tech innovation. The valuation placed on US markets because of these attributes has increased dramatically. The US equity market now represents over a 75% share of the MSCI World Index. The highest level in the last six decades. A chart from the economics team at Bank of America highlights the extent of this relative valuation expansion next to Europe's developed markets. The valuation associated with US equity markets now sits at nearly four standard deviations above the long-term relative valuation of European equities. European economies and markets have had distinct challenges, but the gap in value between those markets and the US is at levels never before seen in modern times. Can those values extend further? Absolutely. Should we expect continued borrowing and spending from the incoming Republican administration? Despite the long list of concerns, the answer is probably yes.

Source: BofA Global Investment Strategy, GFD Finaeon

Sentiment surrounding the market is extremely bullish. Bank of America's Global Fund Manager Survey recently registered its highest US equity allocation and lowest cash allocation on record. It's safe to say the retail investor is fully on board as well. Globally, cross-sector ownership (household, corporate, financials and foreign) of US equities sits at an all-time high of 31%. Passive investment funds have grown well past the actively managed mutual fund community. The popularity of leveraged ETF's is particularly concerning. Is this one of the next bubbles? Leverage is a wonderful elixir when markets connect back-to-back years of meaningful performance, amplifying your returns thanks to borrowed money. The side-effects of this portfolio boosting trickery are not to be taken lightly, however. Market corrections often happen quickly with a related spike in volatility. Any meaningful downdrafts in indices will have a compound negative effect on portfolios exposed to borrowed dollars. Add to this the influence a small number of very large businesses (The Magnificent Seven) have on the major indices and the reversal could be magnified if the problems stem from the AI driven mania of the moment. Do I sound like a frustrated value investor?



Source: Nomura Vol, Bloomberg

At the portfolio level, despite our conservative positioning, we had another solid year. The composite level return for the Strategic Value portfolio was 17.2% net of all fees, outperforming the Russell 1000 Value Index's 14.37% return for 2024. Performance among the businesses we own was broadly distributed but influenced mostly by our exposure to specific companies in the Industrial, Utility, and Consumer Discretionary sectors. During the final quarter of 2024 we exited two long held positions in Delta Airlines (DAL) and biotech AbbVie (ABBV). Both positions reached levels I believe exceeded a conservative estimate of their fair intrinsic value. Within the model portfolio (my personal account) Delta Airlines returned 77.5% and AbbVie returned 102% during our time as shareholders.

I also made several purchases during the 4th quarter. I added to five separate holdings already within the portfolio that have underperformed expectations but hold significant promise relative to my calculation of full value and potential positive influences that may occur under the new administration. I also added one new position in Capri Holdings (CPRI). The company is in the affordable luxury business as the holding company for Michael Kors, Jimmy Choo and Versace. Capri is a business we've owned previously and sold in August 2023 immediately following the announcement of an $8.5B takeover offer by direct competitor Tapestry (TPR), the owner of Coach and Kate Spade brands. The Federal Trade Commission under Biden's influence sued in November 2023 to block the transaction and ultimately ended the takeover. Capri's share value during this period declined from $54/share in August 2023 to $19/share in October of 2024 when we re-purchased our position as the fundamentals of the underlying business were being ignored by selling holders of the shares. We're hopeful management will adjust their strategy and cost structure while also anticipating a new level of interest in the business will emerge under the new administration and their more friendly approach to mergers and acquisitions. Time will tell.

Finally, the cash management strategy that I run for many of you returned 5.12% for the full year at the composite level net of fees. It's been a welcoming environment these last many years to make a solid return on relatively riskless assets. Savers are finally getting rewarded. I think it's important to mention that we are no longer in an inverted yield curve environment where shorter-dated treasury securities offer a higher yield-to-maturity than longer dated government Treasury bonds. The yield curve has steepened significantly in the last several months, perhaps indicating concerns on US fiscal and inflation risks. Investors are requiring higher returns to lend their money to the US government for longer periods. This is something worth watching as the bond market could be the final arbiter of equity market performance.

We look forward to the year ahead. There are certain to be many significant changes on the political, regulatory, and spending fronts. I'm hopeful the new administration will implement policies that are more supportive to business while maintaining a civil discourse with those who may disagree with certain decisions or actions. It's imperative that a level of discipline is applied to the rampant borrow and spend approach. I'm afraid that may be more than we should expect. The beat goes on until something gives…….

I appreciate your friendship and confidence. Please feel free to reach out if I can be helpful with any investing needs you, a family member, or a friend might have.

Drew
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