INVESTMENT UPDATE

2024 Recap: Surprisingly Good Returns -- Few Economic Surprises

Few entered 2024 expecting 25% returns for equities. No major firm on Wall Street had an S&P 500 target north of 5500, let alone 6000. From the first half AI surge to the post-election "widening out" trade, 2024 showed that markets can look past a lot of messiness to find reasons to push higher.

The year ended with equities broadly higher (25%) while bonds again struggles, with the AGG returning 3% less than its yield.

The year was marked by continued geopolitical tensions, a record wave of global elections, tumult in Southeast Asia, progress in Argentina, and frustrations across the US. Inflation continues to remain sticky, wages continue to edge higher, debt continues to surge, and corporate profitability remains near record levels. It's a recipe that many wonder how long it can last.

VALUATION ALWAYS MATTERS...ESPECIALLY NOW!

Calendar Year 2024 was another exceptional year for equity investors. The key word is "exceptional" and not normal or usual. As such, exceptional phenomena (by definition) do not often happen repeatedly. Entering 2025, investors are wise to skew somewhat defensive and skeptical. That doesn't suggest guessing or timing the markets, but rather being aware of the setup entering the year.

Please find below one of the best illustrations ever given about the principal of value from the late Art Cashin (from a CNBC Article in November):

To explain price discovery, Cashin liked to tell the story of the time the jeweler Charles Lewis Tiffany tried to sell an expensive diamond stickpin to John Pierpont Morgan.

Tiffany, Cashin said, knew that J.P. Morgan loved diamond stickpins, which he used to put in his tie. One day, the jeweler sent a man around to Morgan's office with an envelope and a boxwrapped in gift paper. Morgan opened the envelope, and in it was a message from Tiffany: "My dear Mr. Morgan, I know of your great fascination with diamond stickpins. Enclosed in this box is an absolutely exquisite example. Since it is so exquisite and unusual, its price is $5,000."

In those days, Cashin noted, $5,000 was north of $150,000 in present dollars.

The note continued: "My man will leave the stickpin with you and will return to my office. He will come back tomorrow. If you choose to accept it, you may give him a check for $5,000. If you choose not to accept it, you may give him the box back with the diamond stickpin."

The next day, Tiffany's man came back to see Morgan.

Morgan presented him with the box rewrapped in new paper, along with a note, which said, "My dear Mr. Tiffany, as you've said, the stickpin was magnificent. However, the price seems a bit excessive. Instead of $5,000, enclosed you will find a check for $4,000. If you choose to accept that, you may send the pin back to me, and if not, you may keep the pin and tear up the check."

The man returned to Tiffany, who read the note and saw the offer for $4,000. He knew he could still make money on the offer, but felt the pin was still worth the $5,000 he was asking.

The jeweler said to the man, "You may return the check to Mr. Morgan, and tell him I hope to do business with him in the future."

Tiffany then took the wrapping off the box, opened it up and found not the stickpin, but a check for $5,000 and a note that said, “Just checking the price.”

As investors, we cannot control what markets do over days, weeks, or months but we know what they have achieved over the years. As advisors, our role is to embrace favorable risk/reward opportunities by acknowledging that the price paid matters for any security. Given his recent divestiture, it’s unlikely Buffett has soured on Apple as a business and far more likely he feels that its growth has slowed down and that it is less attractive to him as an investment. **As he remarked many years ago, “Price is what you pay…value is what you get.”**

When a stock is relentlessly pushing higher, this can be hard to see. Momentum can cause valuation to seem trivial for extended periods… consider recent examples like MRNA, SQ, PLTN. These may one day recover, but the price paid along the way mattered. Below are a couple of historically great companies that proved challenging stocks to own for lengthy periods of time) all adjusted for splits and buybacks):

- MSFT flat from Dec 1999 to July 2014
- ORCL flat from Jun ’00 to Dec ‘16
- XOM flat from Sep ’06 to Jan ‘21

As an investor, owning great companies is a part of the recipe. Owning them when valuation and fundamental opportunity make sense is equally important!

Starting point matters when doing “stock math.” If a stock trades at 25x earnings and is growing earnings at 10% per year, the stock should produce 10% per year growth if valuation stays at 25x. The way that stock moves faster is when the 25x goes higher and, vice versa, it produces less than 10% if the stock valuation gets cheaper. A stock trading at 13x EPS and growing at 10% per year **may** have more upside than one trading at 25x growing at 10% per year (and less downside during a correction).

Today’s markets boast a lot of stocks trading above their own historical averages and those of the broader market.Owning these names and on a meaningful scale means not owning what has recently been in favor. Below are a few examples of such types of investments. Not all of these “cheap” stocks will be winners…some stocks stay cheap for a reason. ***Furthermore, none of this can be used as a timing mechanism! Irrational valuations can persist for a long time.***

Stock	Trailing P/E	Stock	Trailing P/E
WMT	37.5	NKE	23
KO	26	QCOM	18
AAPL	42	XOM	13
COST	56	MRK	21
AMGN	33	GOOGL	26
MSFT	36	JPM	13

We are not recommending selling those on the left to buy those on the right, but rather suggesting that room for error for those on the left is much smaller than those on the right.Costco, for example, is priced for exceptional execution well into the future while NKE is rightfully being punished for some poor decisions in recent years. It’s likely, however, that NKE will outgrow KO over the next decade and, if that proves true, should reward investors accordingly.

As we move ahead, we believe looking different that the broad indices will allow investors the best ability to capture hidden opportunities and weather whatever storms may lie ahead. This doesn’t mean neglecting ownership of Mega cap tech or any other segments of the market, but rather a tactical overweight to less expensive segments. We expect today’s $Trillion companies to continue growing well into the future but believe there’s a cohort of smaller companies that will grow at a faster pace in the coming decade.

We believe it’s a perilous decision to resist innovation and change. Just recently we encountered a list of things that didn’t exist 25 years ago.Included were iPhone, Tesla, X, YouTube, Gmail,

Facebook, Netflix Streaming, Uber, Airbnb, and Spotify. A lot has changed, and advances happen every day.The human genetic code hadn't been mapped when we graduated college. Imagine what the next 25 years could bring!

We are positioning for innovation in AI, spending on the electrical grid, enhancements to productivity, medical advancements and reshoring of manufacturing to the US. Whatever happens, we expect twists and turns to be plentiful along the way. The chart below is evidence of just how much leadership can change...

Top 5 global companies					
2000	2005	2010	2015	2020	2024
GE	XOM	Petro China	AAPL	Saudi Aramco	AAPL
XOM	GE	XOM	XOM	AAPL	MSFT
MSFT	MSFT	MSFT	MSFT	MSFT	NVDA
PFE	C	ICBC	BRKA	AMZN	AMZN
WMT	BP	BHP	GOOG	GOOG	GOOG

SO, JUST BUY CHEAP STOCKS?

No! Our message is to be keenly aware of valuations and how much exposure you have in "richly valued" stocks. Not all expensive stocks get cheaper by their prices falling. Some companies (like NVDA over the last couple of years) have grown into their valuations. It's when such companies miss expectations that investors can see painful corrections (2022).

With valuations of the Mega Cap leaders (Apple, Meta, Nvidia, Amazon, etc.) priced for strong growth ahead, one must remain attune to the differences by company (they don't all deserve the same valuations) and the innovations each has ahead. The opportunity-set for Apple and Amazon look very different and those should be reflected in the pricing.

Why does valuation matter when we are talking about the best companies on the planet? They have wide moats versus competition and rock-solid balance sheets. Despite all of that, they are not immune to 40-50% corrections.

Overpaying for a great business is still overpaying! Patience in allocating capital is likely rewarded in 2025.

All the above points to one common thread...active management. Active management is paying a manager to look different than the index. Consider a few of the key differences between owning an index and an actively managed portfolio.

Index	Actively Managed Strategy
Only defense is diversification	Actively / structurally seeks to manage risk
Low cost, somewhat static portfolios	More expensive (range is wide) with turnover based on opportunity set
Weightings equal to "what's worked" weightings	Can explicitely own what is attractively valued for the future
No consideration given to price nor value	Can underweight or elect not to own securities based on valuations
NOT always going to outpace active strategies	Not aiming for 100% winners (50% winners over time can lead to huge success)

2025 WILL BE _____?

The S&P 500 is not cheap. The Fed path is Uncertain. The Trump administration is bound to be unpredictable...

Much ink has been spilled trying to predict what lies ahead in the next year. While we will not try to project what 2025 will bring in totality, below are a few of the key items we are watching.

The Year the Fed Pauses

In its most recent press conference, the US Federal Reserve pointed to a data-dependent path of uncertainty ahead. Consensus entering 2025 is for two more 25bp cuts in 2025, but that remains to be seen. Some fear a rate hike before 2025 draws to a close, with resurgent inflation not ruled out. They point to the potential impact of tariffs and dismiss the idea of moderating housing and insurance costs. Energy and food costs are likely to remain wild cards.

We sincerely believe that the Fed (in aggregate) remains data dependent and that they are at the mercy of US Fiscal policy.No amount of Fed action or rhetoric can reverse the impact of Congress spending $ Trillions more than tax receipts

The Year Trump Shakes up DC

The Trump Administration 2.0 has bold plans…but how many become reality? Will DOGE find ways to save money that Congress will agree to? Will the deregulation and tax cutting proposed find its way into law? What will happen on the immigration and national security fronts? Will we negotiate peace in Europe?

Odds suggest not all of these will become reality and the excepted impact may not be what some initially "priced in." Perhaps the greatest win for year 1 of the Trump administration would be getting even the slightest bit of agreement on fiscal restraint.One can hope…

The Year Valuations Again Matter

With forward valuations for the S&P 500 resting at around 23x, it's very hard to make the argument that the markets are cheap. Fixed low costs of capital, strong balance sheets and margins, a lower corporate tax structure, and market structure (greater % in technology) suggest P/E ratios should be higher than past eras. But this much higher is debatable.

It is quite appropriate to believe that market performance in 2025 will be highly correlated to the earnings performance of its member companies. Expectations are high (double-digits) across nearly every sector.AI, infrastructure spending, HealthCare innovation, financial deregulation, a pick-up in M&A, and a renewed IPO market are all themes that have pushed markets to their current levels. Failure to deliver on multiple fronts could force markets to be repriced lower. Delivering on expectations could allow the S&P 500 to press toward the 6600 consensus 2025 year-end target.

The Year of Bonds

Two years ago (2022) the US bond market posted its worst year since the end of the US Civil War. Since that time, pundits have been arguing for the "year of the bond" when the duration trade rewards investors with outsized gains in fixed
income. For this to materialize, the Fed would have to cut rates further than the markets have currently priced in. Such a scenario would most likely accompany economic weakness in the US. This is NOT our base case.

In fixed income, we see the best opportunity in higher yielding lower duration segments of the market. Areas like short-duration high yield, securitized credit, institutional preferreds, and short-duration core plus strategies offer higher yields than US Treasuries without undue exposure to policy movements by the Fed.

As many have heard us say, we don't believe a bet on duration is a high-probability bet. We advocate (and are positioned for) a continually growing US economy and an uncertain path for Fed policy. Whether the 10-year bond ends 2025 nearer 3.5% or 5.5%, we seek to generate a healthy and low-correlated return in bonds. As 2023 and 2024 have shown, this is both plausible and differentiated in the industry. For a second straight year, our fixed income portfolios outpaced the Bloomberg Aggregate Bond Index by more than 5% annually.

HEAD INVESTMENT
PARTNERS

2280 Valley Vista Road
Knoxville, TN 37932
865-999-5332

Past performance is not a guarantee of future results. Securities offered through Osaic Wealth, Inc. member FINRA/SIPC. Investment Advisory services offered through Osaic Advisory Services, LLC (Osaic Advisory). Osaic Wealth and Osaic Advisory are separately owned and other entities and/or marketing names, products or services referenced here are independent of Osaic Wealth and Osaic Advisory.