

# Economic & Market Outlook

## Executive Summary

- ~ We are nervous, but should we? It seems everyone is bullish on U.S. stocks, and after years of outperforming their long-term averages, U.S. stocks are trading at lofty valuation multiples relative to history.
- ~ The good news is that the deeper we dig into the data, the more comfortable we become. While it's true that U.S. stocks aren't trading at bargain-basement prices, their quality makes the overvaluation more understandable.
- ~ Non-U.S. stocks, on the other hand, are being heavily discounted. While the discounted valuation relative to U.S. stocks is partially justified by their lower levels of profitability, has the market taken it too far?
- ~ Arguing for diversification isn't exciting. The diversified portfolio is inherently the most boring - never the best and never the worst - but given today's backdrop, it's hard for us to recommend anything else.

## Introduction

We're worried - nervous, to say the least. U.S. equities, which account for roughly 67% of the global equity market and represent our largest exposure, appear priced for perfection. This isn't an atypical feeling for us. We have spent the better part of our careers in this state - constantly worrying about what could go wrong. Our firm's ethos has always been to worry about the downside; the upside will take care of itself.

To start the new year, we wanted to take inventory of the data, some of which is anecdotal, and ask whether our fears are justified. Are we falling back on heuristics, or are we examining opportunities in a deliberate and intellectually honest way? The answers, as always, are nuanced.

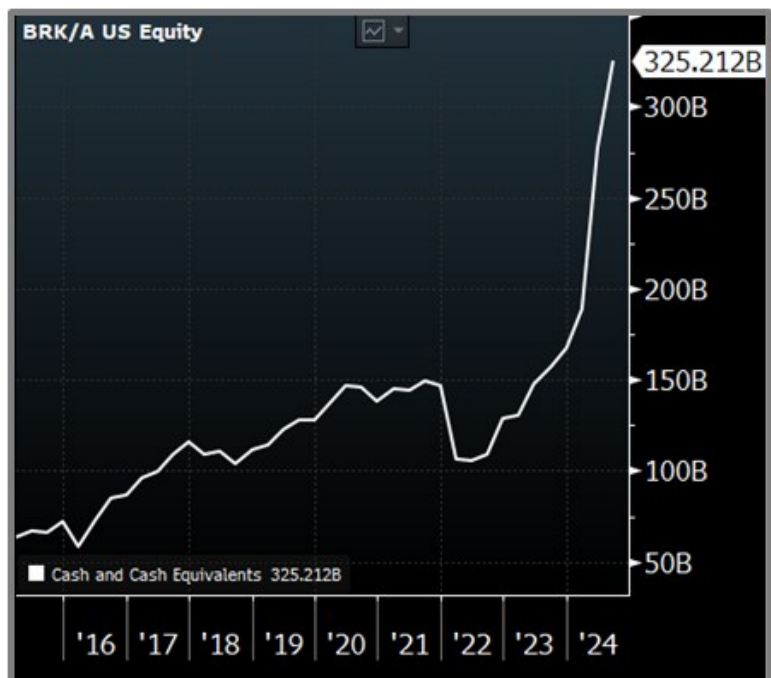
## Observations: Scared Idols

Let's start with the most anecdotal of data.

Many of the investors we most respect are signaling caution. Howard Marks, co-founder of Oaktree Capital, recently penned a memo titled *On Bubble Watch*. He highlighted today's level of optimism, the broad-based overvaluation across sectors, the frenzy surrounding artificial intelligence ("AI") - including its spillover into non-AI stocks, and the implicit presumption that the Magnificent Seven will continue to be magnificent. Marks stops short of declaring a bubble, but his concerns resonate with our own.

Similarly, Warren Buffett has been accumulating cash at a rapid clip. While Berkshire Hathaway's size limits where and how he can invest, his decision to sell 600 million of his 900 million Apple shares since year-end 2023 seems driven by valuation concerns. These moves suggest a broader caution in how Berkshire is approaching the current market environment.

*Berkshire Hathaway is Hoarding Cash*



Source: Bloomberg

That said, blindly following your investment idols is a fool’s errand. There is no personal growth to be gained, and no substitute for independent analysis. After the financial crisis, many investors were placed on pedestals for profiting from the subprime crisis, only to deliver lackluster returns in the subsequent decade. Oaktree and Berkshire have impressive long-term track records, but in the realm of finance no track record is long enough. Even the great investors err in judgement.

**Observations: Abundant Enthusiasm**

Another pure anecdote is the level of optimism about the future.

Attitudes regarding the trajectory of our economy have two tailwinds. The majority believes the Trump administration is the prescription required to boost growth. You could see it in the reaction stock prices had following his victory. Small business optimism was in the dumps at the tail-end of the Biden administration, but since Trump’s victory it has spiked towards all-time highs (see the chart below). The second economic tailwind is the rise of Artificial Intelligence, which has the potential to reset global labor productivity. Per Goldman Sach’s, “assuming workers aren’t permanently replaced by automation and there’s capital to support the increase in productivity, the increase in productivity could boost long-run worldwide GDP by as much as 15%.”

*NFIB Small Business Optimism Index*



Source: Bloomberg

Today’s optimism is even evident in the markets. US households have record-high allocations to equities, reflecting not only rising valuations but also significant inflows to stocks. A November Bloomberg headline read, “Trump Win Spurs ETF-Buying Bonanza as Traders Pour In.” A Haver Analytics survey found that over half of Americans expect stocks to be higher in 12 months (see chart below). The credit markets tell a similar story. US high-yield spreads are near their lowest level in history, currently 2.7%, indicating there is little concern of a coming default cycle.

*51.4% of Americans Surveyed Think Stocks Will be Higher in 12-Months*



Source: Apollo

The fever for US stocks has even gone global. In Japan’s tax-advantage NISA program, the most popular holdings include Nvidia, Tesla, and AI-driven companies like Palantir. Things are awry when a company like MicroStrategy, engineers a strategy to purchase bitcoin using convertible debt, appreciates ten-fold, to \$107 billion capitalization, even though the value of its underlying bitcoin holdings are worth a small fraction of that. You know retail speculation is running rampant, when a cryptocurrency called Fartcoin sports a market capitalization north of \$1 billion.

These symptoms may merely be spurious anecdotes, but they are abnormal symptoms warranting attention.

**Observations: Extraordinary US Stock Returns**

This is the simplest observation: US equity returns have been above average. The S&P 500’s total return index is one standard deviation above its 35-year trend line (see the logarithmic scale chart to the right), a period in which stocks compounded at 11.3%. Recent returns have been abnormally strong, 25.6% per annum over the past two years, 14.5% per annum over the past five years, and 13.1% over the past decade. This of course is just an observation that adds to our unease, but should it? Since 1928, US stocks have returned 9.7% annually, but there is no stated rule that long-term US stock returns must continue this trend. Maybe the new trend is higher.

*The S&P 500 is 1 Standard Deviation Above Trend*



Source: Bloomberg

**Observations: Valuations are Historically High**

The most alarming and objective data point is our recently elevated returns have been fueled, in part, by expanding valuation multiples. Over the past decade, the forward price-to-earnings multiple for the S&P has risen from 16.5x to 21.8x. Put another way, investors are paying more for each dollar of earnings, which has added 2.8% to annual returns. The impact of expanding valuations is even more drastic if you examine shorter time horizons.

*S&P 500 Forward Earnings Multiple*



Source: Bloomberg

When viewed through various valuation metrics, such as price-to-sales and enterprise value-to-EBITDA, stocks look expensive by historical standards. The dot-com bubble of the late 1990s is the only comparable period. Yet, today's market differs significantly in profitability, a topic we will address later.

*The Metric Doesn't Matter. Every Valuation Multiple is At or Past Historic Extremes*

Metrics	Aggregate index		Median stock	
	Current	Historical %ile	Current	Historical %ile
EV / sales	3.4	100 %	3.5	97 %
Cash flow yield (CFO)*	5.1 %	100 %	5.8 %	95 %
Price / book*	5.3	99 %	3.7	98 %
EV / EBITDA*	16.5	97 %	13.8	94 %
Forward P/E	22.3	95 %	19.2	95 %
Cyclically adjusted P/E (CAPE)	34.3	96 %	NA	NA
Free cash flow yield*	2.9 %	77 %	3.6 %	63 %
<b>Median absolute metric</b>		<b>97 %</b>		<b>95 %</b>
Yield gap vs. real 10-year UST	240 bp	91 %	310 bp	90 %
Yield gap vs. 10-year UST	6 bp	89 %	76 bp	71 %
Yield gap vs. IG**	-76 bp	88 %	-5 bp	84 %
<b>Median relative metric</b>		<b>89 %</b>		<b>84 %</b>

\*data since 1987  
\*\*data since 1999

Source: Goldman Sachs

**A Quick Rebuttal: The Problem with Mean Reversion**

Our concerns surrounding the S&P 500's above-average returns and historically elevated valuations assume that returns and valuations will revert to the mean. It wouldn't be pleasant if U.S. stocks reverted to historical averages. This was briefly alluded to earlier, but what determines the appropriate long-term rate of return on stocks? What sets the fair valuation multiple (P/E, EV/EBIT, EV/EBITDA, P/S, etc.) for stocks? Anyone can calculate a historical average. Is market timing really so simple that all it takes is buying stocks when returns or valuations multiples are sufficiently below average and selling when they are sufficiently above average? Of course not. Unfortunately, investing is far more nuanced than that.

**Comparing Today's Market to the Dot.com Bubble**

Take the multiple of sales at which the S&P 500 trades. Today, it is the highest it has ever been, surpassing the dot-com bubble. In fact, it is 34.9% higher, which at face value is scary, given that the dot-com era was a massive bubble.

*S&P 500 Price-to-sales Multiple at the Highs*

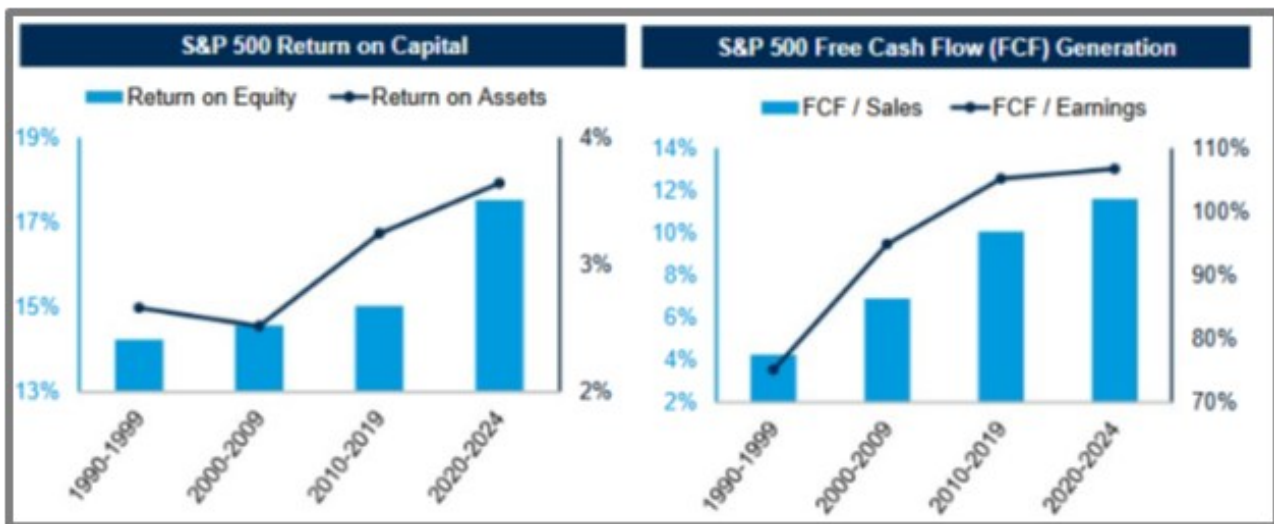


Source: Bloomberg

Now consider all the reasons we may be drawing the incorrect conclusion from history.

The use of leverage (debt) has decreased over time. In 1999, the S&P 500 was financed with roughly two dollars of debt for every dollar of equity, whereas today debt-to-equity ratios are around 116%. Although enterprise value-to-sales multiples are now 8.0% higher, or 34.9%, which is slightly less concerning, the more significant change has been in profitability. The returns companies generate depend on profit margins and asset turns, and since the dot-com bubble, profit margins have consistently trended higher, while asset turns have remained steady, resulting in more profits for every dollar of assets deployed. This increased profitability is driven by several factors. The companies dominating the S&P 500 today, including Apple, Amazon, Google, Meta, Microsoft, Nvidia, and Tesla - the “Magnificent 7” - are economically stronger than those in the past, collectively generating 23.5% profit margins. Additionally, until recently (2022), interest rates were in secular decline, allowing large corporations to lock in debt at historically attractive rates, while corporate tax rates have steadily decreased, further boosting profitability.

#### *The Current Roster of US Stocks is Just Better*



Source: Unknown, but we confirmed the data

Given that the S&P 500 is considerably more profitable today than it was in the past (such as during the dot-com bubble), it makes sense that it would trade at a higher multiple. This is akin to buying a money tree. Imagine there is a Dogwood and a Sycamore, both with leaves made of dollar bills. Initially, they have the same number of leaves, but the Dogwood’s leaves increase by 4% annually, while the Sycamore’s increase by 6% annually. If such a fantasy existed, wouldn’t you expect the Sycamore to cost more? The point we are trying to stress is that a fair valuation multiple has little to do with history and much to do with future profitability. History can serve as a guardrail, informing our expectations of what is likely and what might be abnormal, but it doesn’t tell us everything.

Valuation multiples deserve to be higher today because public companies have been more efficient at turning the dollars they generate (earnings) into even more dollars (future earnings). The real question is: How much higher should valuations be?

#### **What is Determines Fair Value? What Determines a Stocks Multiple?**

The intrinsic value of any asset is a function of the cash flow it produces. For some assets, like Treasuries or fixed annuities, future cash flows are predictable, but that’s not the case for stocks. For stocks, future cash flows depend on future profitability and future reinvestment. The more profitable a company is, the less cash it needs to reinvest to maintain an equivalent level of growth. We’ve illustrated this point in the following table, which shows potential earnings growth as a function of profitability (return on equity) and reinvestment rates. As you can see, a company that generates a 20% return on equity and retains only 40% (i.e., pays out the other 60% to shareholders) can grow future earnings at an 8% rate. In contrast, the company that earns a 10% return on equity and retains only 40% is limited to 4% earnings growth. Apologies for belaboring this point, but it helps explain why valuation multiples are higher today.

In its current composition, the S&P 500 is the most profitable it has ever been, and it is very efficient at turning earnings into more earnings.

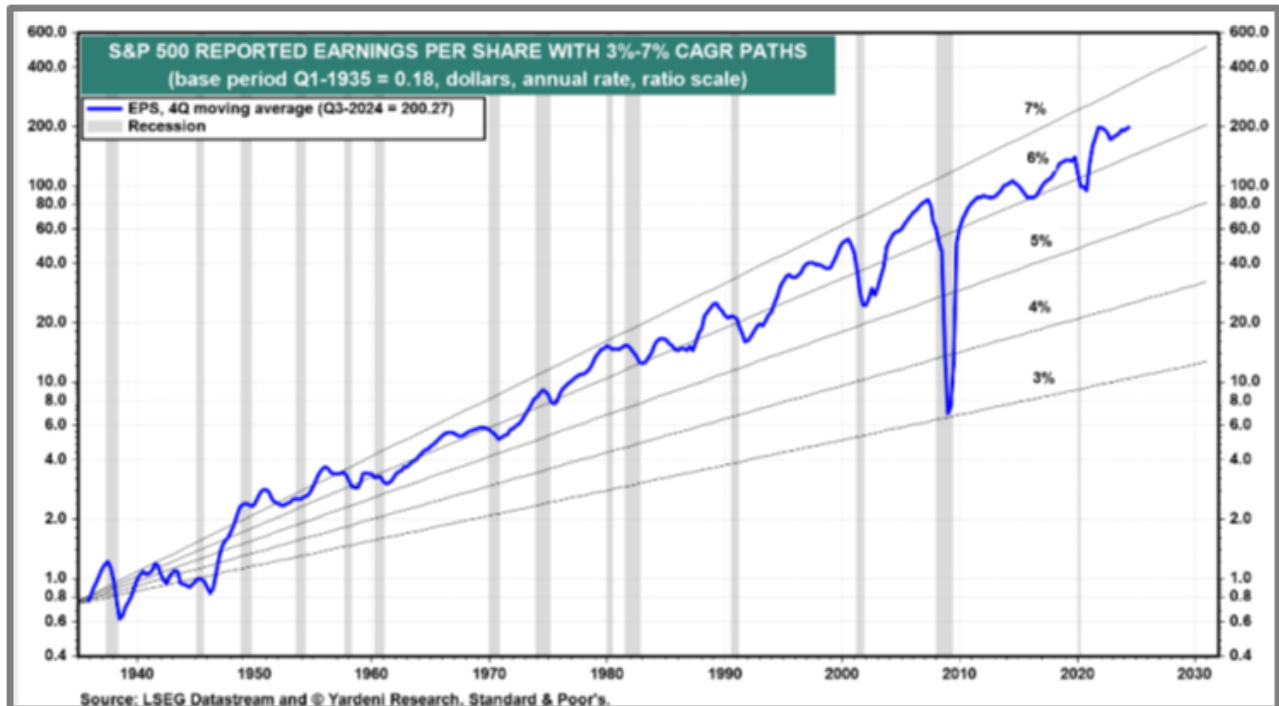
*Highly Profitable Companies Require Less Reinvestment To Achieve the Same Level of Growth*

		Return on Equity				
		5%	10%	15%	20%	
% Reinvested Earnings	20%	1.0%	2.0%	3.0%	4.0%	80%
	40%	2.0%	4.0%	6.0%	8.0%	60%
	60%	3.0%	6.0%	9.0%	12.0%	40%
	80%	4.0%	8.0%	12.0%	16.0%	20%

Source: Annandale Capital

If you believe today’s levels of profitability, and in turn earnings growth, will persist, then today’s valuations are only mildly concerning. Over the past 90 years, S&P 500 earnings have grown 6-7% nominally. At present, the index supports a 1.41% dividend yield and a 1.7% buyback yield. If you think earnings per share growth can persist at 6.0%, then stocks should deliver a long-term return of about 9.1%. That return is well below the S&P’s recent experience - 14.5% over the past five years and 13.07% over the past decade - but it’s not the end of the world.

*S&P 500 Earnings Growth 1935 to Present*

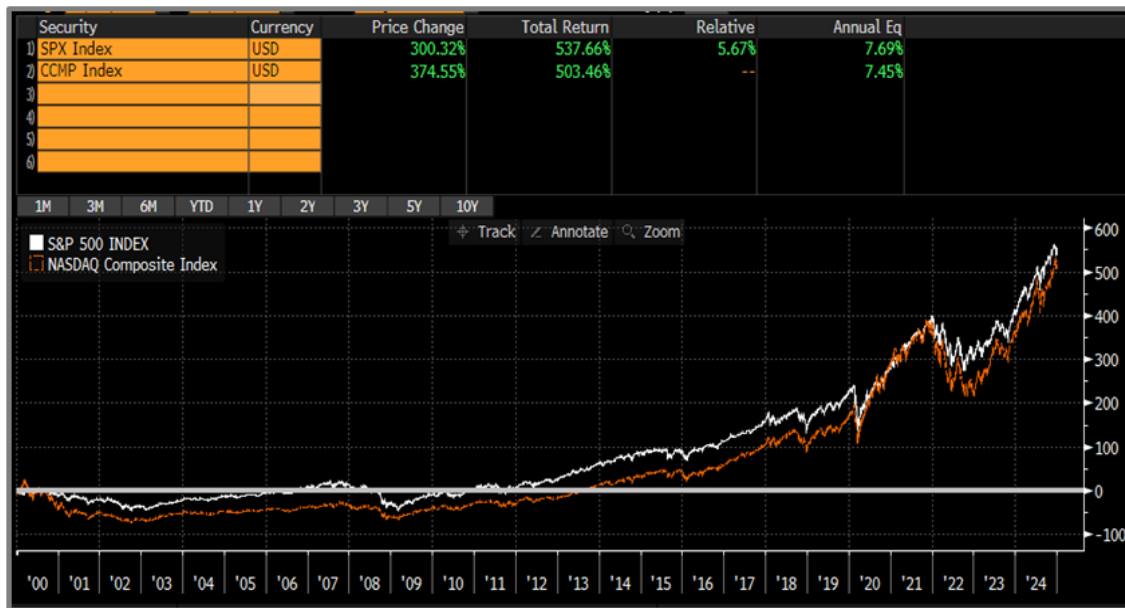


Source: Edward Yardeni

**Taking Comfort in History**

Valuations were far more extreme during the technology bubble of the 1990s. While headline multiples were comparable to today’s levels, it’s important to remember that the index was far less profitable back then. Out of curiosity, we decided to calculate total shareholder returns assuming we had invested all our savings into the Nasdaq (which had more extreme valuations) and the S&P 500 in December of 1999. The result was surprising. *See graphic on next page.*

*Even With Awful Timing the Long-term Results Are Palatable.  
An Investor Who Top-Ticked the Dot.com Bubble Has Compounded at 7.7%*



Source: Bloomberg

Despite the horrendous timing, both the S&P 500 and Nasdaq went on to compound at 7.7% and 7.5%, respectively. While these aren't stellar returns, and the ride would have been difficult, it's a far cry from losing money - and the return comfortably outpaces inflation. This serves as a good reminder that time in the market is more important than trying to time the market

### Taking Comfort in Action

We also asked ourselves, if the S&P 500 were to fall 20% tomorrow, would we be buyers or sellers of its constituents? This exercise is far from an exact science, but our thinking was that if stocks still looked expensive after a 20% drop, we might have a real problem on our hands. Admittedly, we didn't do a deep dive into all 503 companies (yes, we know there are 503), but we did some quick math on the 22 largest companies, which make up about 50% of the index. The multiples shown here account for the 20% price decline. Our gut feeling was that 14 of the 22 companies - 54% by weight - would still be buys if such a move occurred, and about 74% of the companies traded at reasonable or better valuations.

#### Would You Buy on a 20% Decline?

Ticker	Weight	Cumulative	Market Cap (\$b)	Multiple #1	Multiple #2	Other Metrics	Notes
AAPL US Equity	7.3%	7.3%	\$ 3,703	EV/EBIT 22.2x	25 FCF Yield 4.0%		Seems fair... will be close to 50% EBIT from Services
NVDA US Equity	7.2%	14.5%	\$ 3,655	EV/EBIT 36.4x	NY EV/EBIT 24.0x		Cyclical and depends on cycle
MSFT US Equity	6.3%	20.8%	\$ 3,192	EV/EBIT 21.0x	NY EV/EBIT 18.3x		Seems like a great deal for most dominant software
AMZN US Equity	4.2%	25.0%	\$ 2,378	EV/EBIT 29.6x	NY EV/EBIT 24.3x		Great deal / multiple overstated / most durable asset
GOOGL US Equity	4.1%	29.1%	\$ 2,450	EV/EBIT 17.1x	NY EV/EBIT 14.9x		Very low valuation reflecting AI risks to search
META US Equity	2.7%	31.8%	\$ 1,580	EV/EBIT 18.9x	25 EV/FoAEBIT 13.0x		Extremely low valuation unless social dying
TSLA US Equity	2.3%	34.1%	\$ 1,315	EV/EBIT 87.1x	NY EV/EBIT 65.7x		Nope
AVGO US Equity	2.2%	36.3%	\$ 1,088	EV/EBIT 38.4x	NY EV/EBIT 29.8x		Cyclical
BRK/B US Equity	1.6%	37.9%	\$ 976	P/B 1.2x			Below buyback levels
JPM US Equity	1.3%	39.2%	\$ 679	P/B 1.7x	P/E 11.1x		Low to fair valuation... depends on sustainable ROE
LLY US Equity	1.2%	40.4%	\$ 736	EV/EBIT 44.8x	NY EV/EBIT 25.8x		Nope
V US Equity	1.1%	41.5%	\$ 632	EV/EBIT 19.0x	NY EV/EBIT 17.2x		Good deal unless rails get intermediated
XOM US Equity	0.9%	42.4%	\$ 476	EV/EBIT 8.1x	NY EV/EBIT 8.3x		Cyclical, so multiple is probably understated
UNH US Equity	0.9%	43.4%	\$ 475	EV/EBIT 12.6x	NY EV/EBIT 11.2x		Valuation already reflects risk to biz model
MA US Equity	0.8%	44.2%	\$ 471	EV/EBIT 25.1x	NY EV/EBIT 21.6x		Good deal unless rails get intermediated
COST US Equity	0.8%	45.0%	\$ 412	EV/EBIT 31.5x	NY EV/EBIT 28.4x		Nope
WMT US Equity	0.8%	45.8%	\$ 733	EV/EBIT 21.5x	NY EV/EBIT 19.4x		Makes sense, but probably not
HD US Equity	0.8%	46.5%	\$ 389	EV/EBIT 16.6x	NY EV/EBIT 16.2x		Good deal
PG US Equity	0.8%	47.3%	\$ 382	EV/EBIT 15.4x	NY EV/EBIT 14.5x		Seems appropriate
NFLX US Equity	0.7%	48.0%	\$ 377	EV/EBIT 29.9x	NY EV/EBIT 24.9x		Seems fair
JNJ US Equity	0.7%	48.7%	\$ 350	EV/EBIT 10.8x	NY EV/EBIT 10.0x		Seems like a great deal
ABBV US Equity	0.6%	49.3%	\$ 320	EV/EBIT 12.3x	NY EV/EBIT 11.1x		Seems like a great deal

Source: Annandale Capital

In summary, we are certainly nervous, but it's hard to argue that investors have collectively lost their minds. Yes, we expect lower returns for U.S. equities going forward, but it isn't the end of the world.

### More Observations: Can It Get Any Better? Part 1

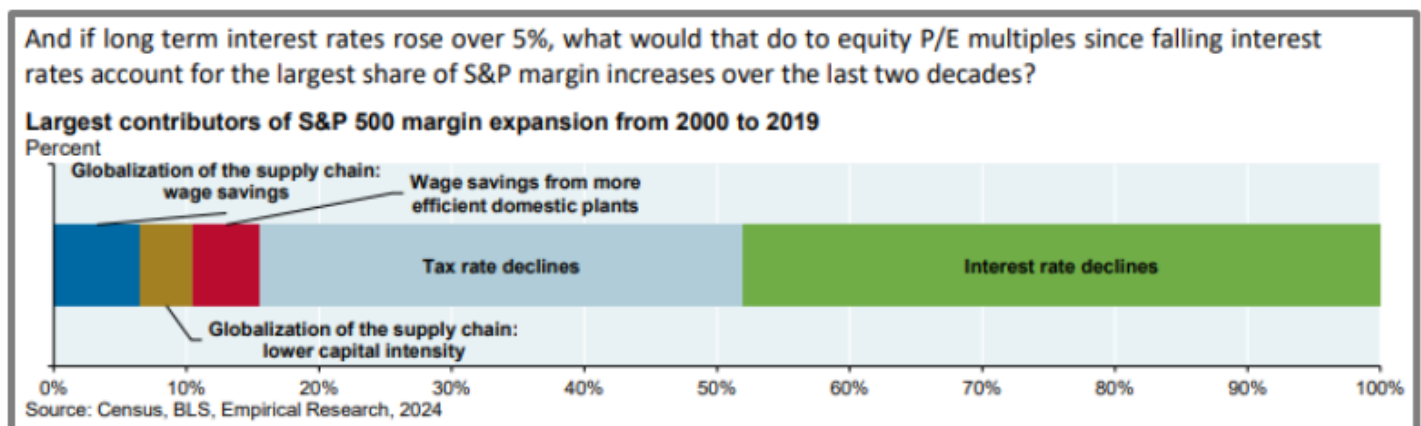
If everything is already perfect in the land of U.S. equities, how can things improve? To put it another way, when conditions are already ideal, they can either stay the same or get worse.

Earlier, we emphasized the importance of profitability, because it dictates how efficiently companies can grow. The steady growth in S&P profit margins has been driven by falling financing costs, decreasing taxes, and a shift in the mix of S&P constituents. Considering what's at stake going forward:

- **Pro:** Trump is proposing cutting corporate taxes from 21% to 15%, which, by our calculations, could improve profit margins by up to 1%. This is a positive development for equities, though not as impactful as his prior corporate tax reform.
- **Con:** After bottoming in 2020, interest rates have steadily climbed. The 10-year Treasury yield is now just under 5%. The cost of new debt issuance - and floating-rate debt - will likely pose a headwind to corporate margins. The good news is that S&P 500 companies are cash-rich and, on aggregate, not highly leveraged. That said, the cash-rich tech companies are rapidly depleting their cash reserves on data center buildouts. If today's rates persist, they will gradually become a headwind for margins.
- **Con:** High-margin technology companies already make up a substantial portion of the index. Apple, Nvidia, Microsoft, Amazon, Meta, Alphabet, Tesla, and Broadcom now comprise over 35% of the index. In fact, the index is as concentrated as it has ever been in either technology stocks or the top ten. Moreover, the rise of AI is altering the economics of these businesses. Nvidia and Broadcom are likely operating at or near peak margins. Microsoft, Amazon, Meta, Alphabet, and Tesla are committing increasing amounts of their free cash flow to purchase GPUs and build out data centers. Alphabet's search business has extremely high incremental margins, but it seems unlikely that "chatbots" can achieve similar levels of profitability as they scale. The same risk could apply to Microsoft's software division.

When we consider all the data in aggregate, it seems possible that margins could fall, and probable that their rate of expansion will slow. A mere deceleration in margin expansion means it will be harder to achieve earnings growth comparable to what we've experienced recently.

#### What Drove Profit Margins Higher for US Stocks



Source: JP Morgan

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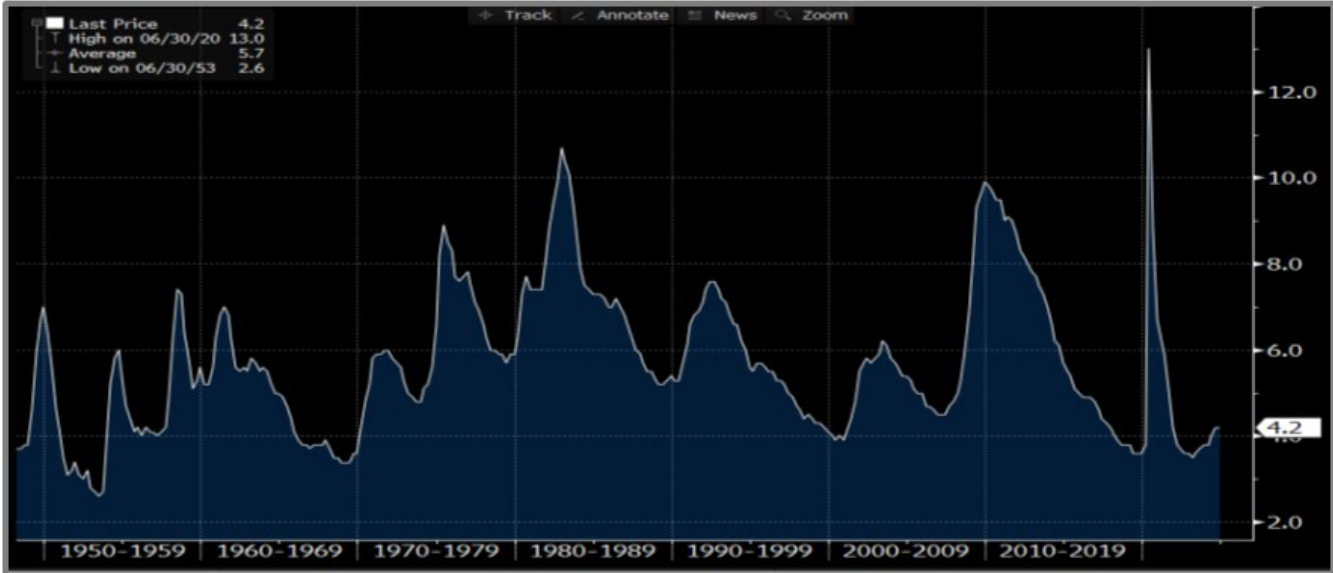


**Observations: Can It Get Any Better? Part 2**

If everything is already perfect in the economy, how much more can it improve?

The resilience of the U.S. economy post-COVID has been remarkable. Despite an aggressive Fed tightening cycle, U.S. real GDP growth remains robust at 3.1%. Consumption, which makes up around 70% of GDP, continues to be the primary driver, and so far, little has been able to curb U.S. consumer spending. Unemployment is at its lowest levels in history, at 4.1%, making it difficult to envision a scenario where the labor economy improves much further. The counterargument is that generative AI could improve labor productivity, but only time will tell. Our simpler conclusion is that if a recession does occur, it will prove painful given the already high valuations of U.S. stocks.

*The Unemployment Rate Doesn't Have Much Room to Improve*



Source: Bloomberg

*US Companies Aren't Firing, but They Also Aren't Hiring*



Source: JP Morgan

## Observations: Be Careful What You Wish For

Democrats and Republicans alike generally agree that government spending is often wildly inefficient, though they frequently disagree on the necessity of that spending. Political views aside, Sancho Panza, Vivek Ramaswamy (no longer), and Elon Musk are spearheading the Department of Governmental Efficiency's (DOGE) efforts to curb wasteful spending. Who knows how successful they will be? Non-defense discretionary spending is at its lowest level in decades. Tackling entitlement spending will be a tough battle, and the legal authority of DOGE and the executive branch to implement changes remains unclear. Still, Elon Musk claims that finding areas to cut is "like shooting fish in a barrel," and he believes they can cut \$2 trillion - about a third of the budget. More tempered estimates suggest \$500 billion in spending cuts.

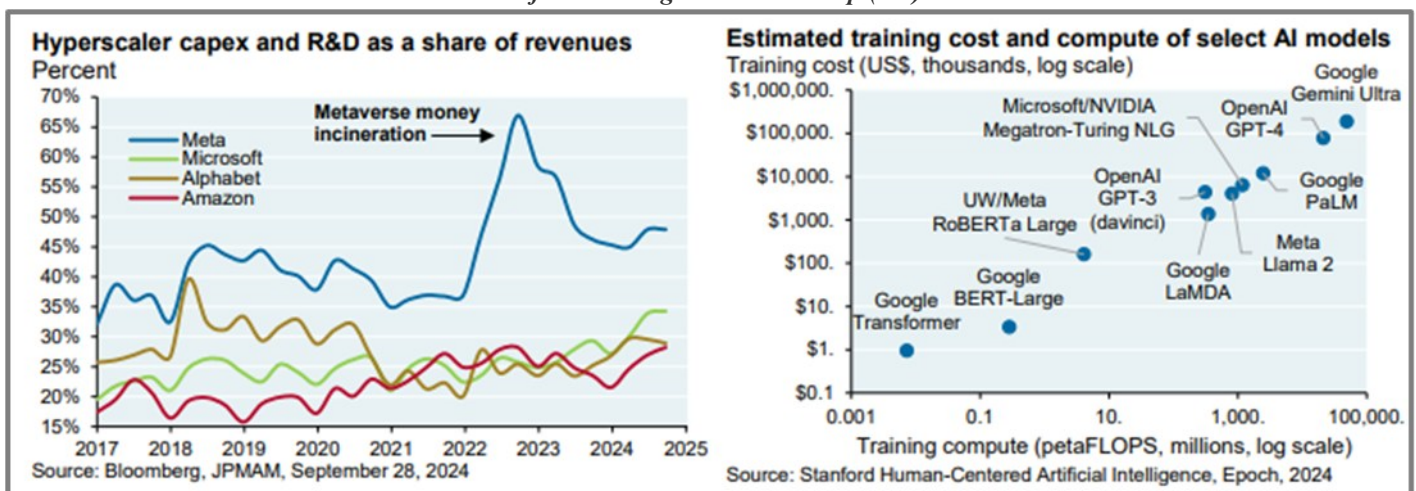
Our office generally supports any efforts to rein in government spending, but we're also mindful of the potential short-term consequences. In finance, there's an identity called the Kalecki-Levy profit equation, which states that profits equal investment plus wages minus consumption plus government spending. If DOGE is successful, it could result in short-term economic damage. In simpler terms, government spending flows to individuals in the form of wages and for corporations (such as government contractors) in the form of revenues, which are then used to pay wages. Cutting government spending may, therefore, reduce economy-wide profits. For perspective, DOGE's \$500 billion goal is equivalent to 25% of the S&P 500's annual profits.

## Observations: Artificial Intelligence

We're not referring to the singularity or the potential for artificial intelligence to render a wide range of jobs obsolete. History has shown that technological revolutions often displace jobs - take the internet, for example, which rendered many print publishing jobs obsolete. What we're focusing on here is the massive investment being poured into AI and the associated returns on that investment.

Building and hosting AI models is costly - very costly. Last April, the CEO of Anthropic was quoted saying, "The models that are in training now... cost closer to \$1 billion... and by 2025 and 2026, we'll be looking at \$5 billion to \$10 billion." That's a staggering amount. Zuckerberg also noted that the compute power needed to train his next generation of models will be 10 times that of the previous generation. The broader point is that building these models is expensive, and there is a fierce arms race to create the most advanced models, which is driving up demand for computing power.

### *Artificial Intelligence Isn't Cheap (Yet)*



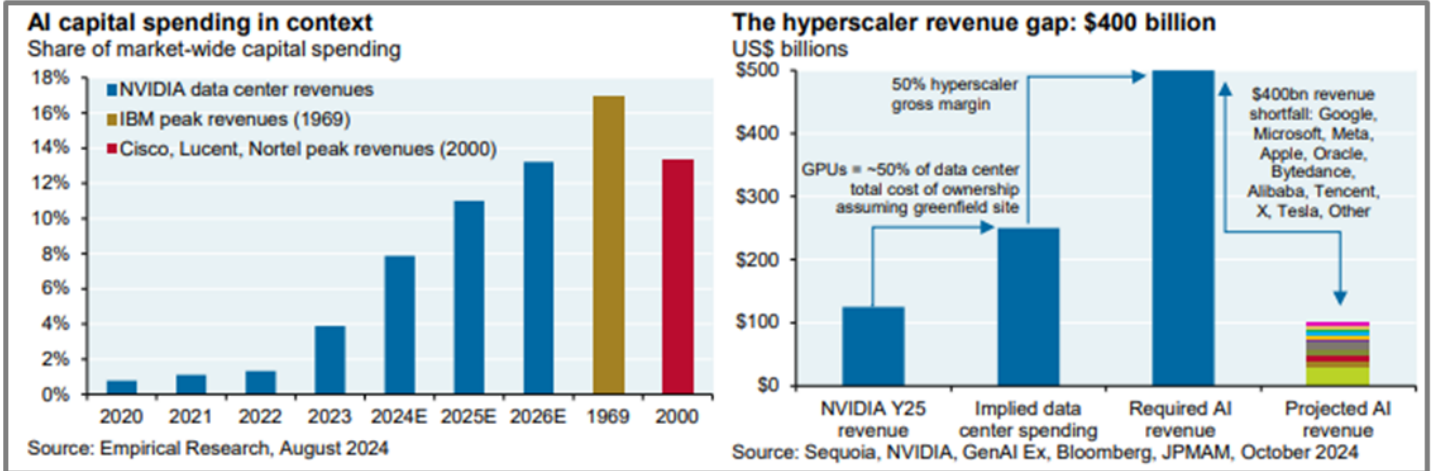
Source: JP Morgan

Before the AI craze, Microsoft was spending about 15% of its sales on CAPEX. Today, that number has risen to 25% and is still growing. And that doesn't even include the additional research and development expenses. Similar trends can be seen at Meta, Alphabet, and Amazon. In 2024, hyperscale CAPEX for these four companies hit \$220 billion - a

a 70% increase from the prior year. By 2025, hyperscale CAPEX is expected to exceed \$300 billion. Almost all of the incremental free cash flow these companies generate is being funneled into the AI race.

If, for some reason, today’s capital spending fails to yield adequate rates of return, it could weigh heavily on U.S. tech stocks and derivative industries (servers, networking, power production, etc.), whose stock prices reflect high expectations for the future of AI.

*Nvidia Accounts for a Large Chunk of US Capital Expenditures. Hopefully, All of Those GPUs Were Worth the Spend.*



Source: JP Morgan

### Reality: There's Always Something

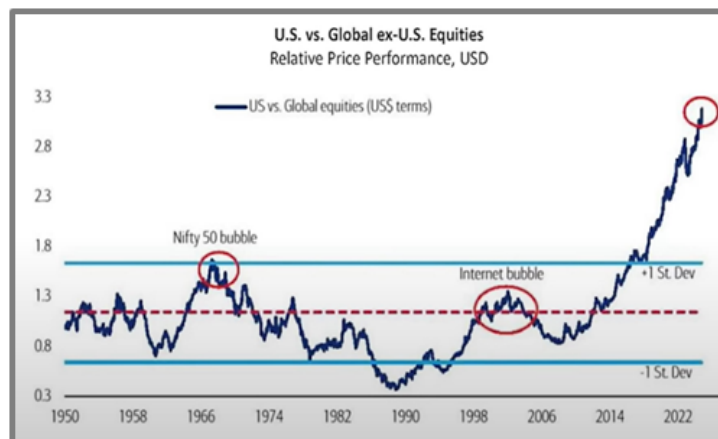
The reality of life is that there is always something to worry about - the unknown implications of Trump’s tariff policies, the threat of global war, or imagine what would happen if war or a natural disaster took out Taiwan’s semiconductor manufacturing capacity. We wouldn’t have enough chips for household appliances, let alone data centers. The bigger risks are likely those we have yet to imagine.

Unfortunately, it doesn’t make sense to eliminate these risks - or the unmentioned ones - from your portfolio. The only way to avoid them entirely is to abstain from investing. That’s what investing is: being paid to take risks. The best we can do is diversify the risks we take, so that no single event - a war, a U.S. recession, or a bust in AI - imposes enough damage to take us out of the game.

### Diversification Pains

For the past decade, holding a global portfolio of stocks has been painful. It’s been painful to hold U.S. small-cap stocks. Frankly, it’s been painful to hold anything other than large-cap U.S. technology stocks. That’s the cost of diversification. A diversified portfolio is never the top performer, but it’s also never the worst.

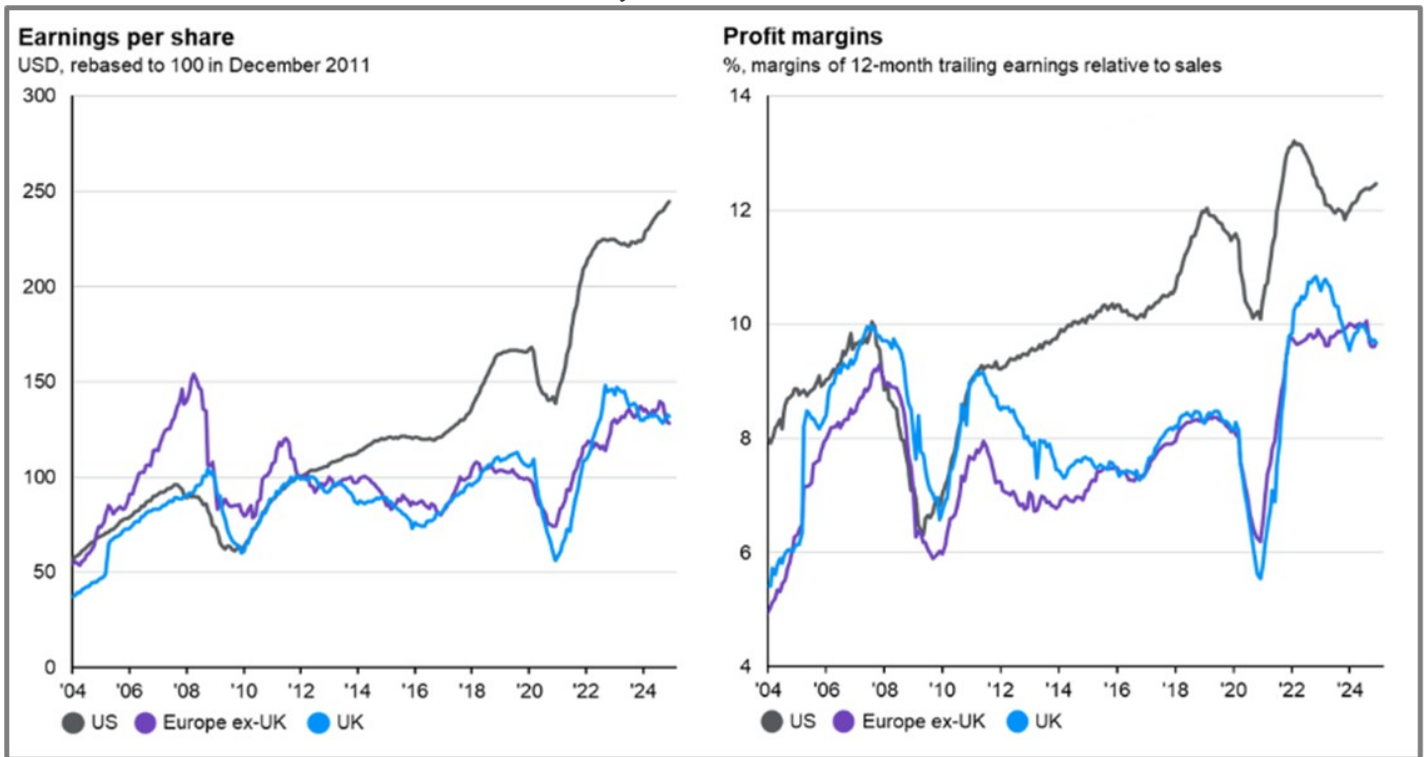
*US Stocks Have Crushed Non-US Stocks (Recently)*



Source: Bank of America

With the benefit of hindsight, some of the outperformance of U.S. large-cap securities (code for mostly technology stocks) was justified. We've covered this before, but the combination of declining interest rates, falling tax rates, and a higher concentration of better businesses led to greater profitability in the U.S., which in turn spurred higher earnings growth. What many refer to as "U.S. exceptionalism" has been a real phenomenon.

*Fundamentally, US Stocks Have Been Better*



Source: JP Morgan

U.S. exceptionalism may continue, and we wouldn't bet against it. The rule of law is more reliable than in many ex-U.S. markets. Europe's economy is stifled by regulation. U.S. labor output per worker is nearly 15% higher than in Europe. U.S. profit margins are about 2% higher than those abroad. No matter how you slice the metrics - economic or financial - U.S. companies have had a better track record over the past decade. U.S. equities are like the 1970s Cowboys or the 1990s Chicago Bulls.

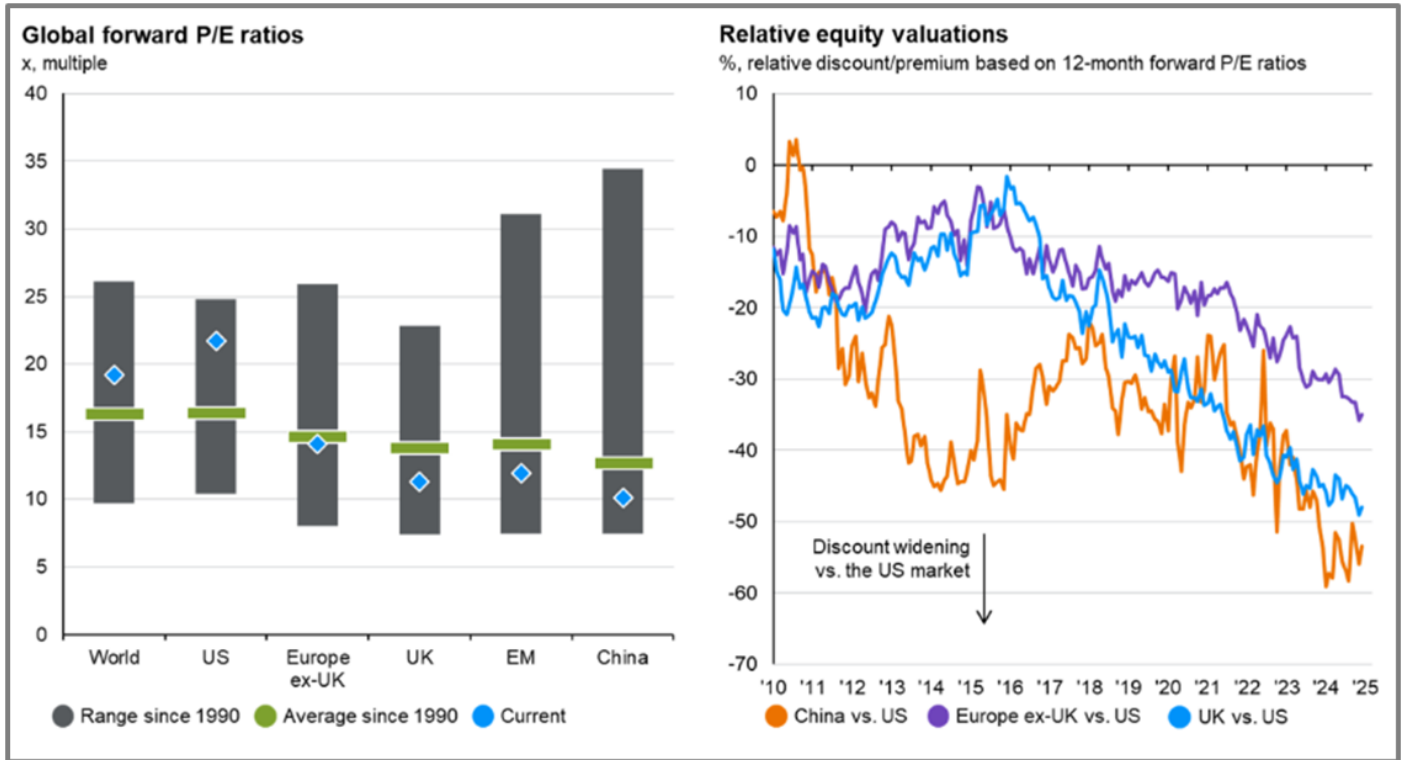
All else being equal, we want to own the best companies. We want companies with long growth runways that will generate high incremental returns on capital and equity. Unfortunately, all else is rarely equal. Even if you could identify the best companies, you must also consider price. No company is so great that you should pay any price.

### The Dogwood and Sycamore Analogy

Let's revisit the analogy of the Dogwood and Sycamore, whose leaves are dollar bills. Recall that the Dogwood's leaves grow 4% annually, while the Sycamore's grow 6%. Views on aesthetics aside, the Sycamore is clearly the more valuable tree. However, there's a price at which you'd prefer to buy the Dogwood. Imagine the market price is 13x the Dogwood's annual production and 22x the Sycamore's. In this case, the Dogwood would produce an 11.7% return versus the Sycamore's 10.5%. The math is simple: it's one divided by the multiple paid, plus the growth rate. This oversimplified example approximates the difference in price between U.S. and European equities. U.S. stocks trade at 22x earnings with 6% growth, while European stocks trade at 13x earnings with 4% growth. Perhaps U.S. exceptionalism is already priced in.

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*Does the Valuation Gap Already Reflect (or Discount) US Exceptionalism?*



Source: JP Morgan

**The Future is Always Uncertain**

We believe that a modicum of diversification is wise, regardless of initial conditions, whether starting valuations or current levels of profitability. The simple reality is that the future is uncertain. Did you know that from 1998 to 2011, a 13-year span, non-U.S. stocks outperformed U.S. stocks? From October 1999 to October 2007, non-U.S. stocks outperformed U.S. stocks by 5.3% per annum. There was even a 41-year period, from 1970 to 2011, when non-U.S. stocks outperformed U.S. stocks on a currency-neutral basis. Who knows what the future will bring, but we feel it would be foolish not to diversify. The favorable initial conditions - low valuations abroad and the concentration of U.S. equities - only reinforce this view.

*US Stock Outperformance Hasn't Always Been Guaranteed*



Source: Avantis

## Conclusion

At the end of the day, you get paid for taking risks. If risks weren't present, equities would trade at much higher valuations, and the returns they offer would be lower. There's a reason 10-year Treasury bonds yield under 5%. Our job is to take intelligent risks, diversifying what we can't control - the future - and seeking select opportunities where the potential upside outweighs the downside.

As always, thanks for taking the time to read our thoughts. It is a privilege to manage your money, and we look forward to catching up.

**IMPORTANT DISCLOSURES** *This material is not intended to be used as a general guide to investing, or as a source of any specific investment recommendations, and makes no implied or express recommendations concerning the manner in which any client's account should or would be handled, as appropriate investment strategies depend upon each client's distinct investment objectives. This is not an offer or solicitation with respect to the purchase or sale of any security. Further information on any of the investments mentioned in this material may be obtained upon request. Before making any investment decision, prospective investors should carefully read all material provided. It is not our intention to state or imply in any manner that past results and profitability is an indication of future performance. The attached summary/prices/quotes/statistics have been obtained from sources we believe to be reliable, but we cannot guarantee its accuracy or completeness. Annandale Capital, LLC does not provide tax or legal advice. Please consult your tax or legal advisor.*