Eubel Brady & Suttman
INVESTMENT + WEALTH MANAGEMENT

Investing in You

MARKET REPORT
FOURTH QUARTER 2024

Key Points

- In some respects, last year's market action reminds us of the late '90s.
- Market concentration remains high.
- We wrap up the Risk vs. Uncertainty and the Decision-Making Process series.
- The range of potential outcomes in the year ahead is wider than usual, in our view.

Total Return as of December 31, 2024

			Annualized			
	QTD	**YTD**	**1 Yr**	**3 Yr**	**5 Yr**	**10 Yr**
S&P 500	2.4%	25.0%	25.0%	8.9%	14.5%	13.1%
NASDAQ	6.4%	29.6%	29.6%	8.2%	17.5%	16.3%
Russell 3000						
Index	2.6%	23.8%	23.8%	8.0%	13.9%	12.6%
Value	-1.9%	14.0%	14.0%	5.4%	8.6%	8.4%
Growth	6.8%	32.5%	32.5%	9.9%	18.3%	16.2%
Russell Mid Cap						
Index	0.6%	15.3%	15.3%	3.8%	9.9%	9.6%
Value	-1.8%	13.1%	13.1%	3.9%	8.6%	8.1%
Growth	8.1%	22.1%	22.1%	4.0%	11.5%	11.5%
Russell 2000 (Small Cap)						
Index	0.3%	11.5%	11.5%	1.2%	7.4%	7.8%
Value	-1.1%	8.1%	8.1%	1.9%	7.3%	7.1%
Growth	1.7%	15.2%	15.2%	0.2%	6.9%	8.1%

A Review of 2024

In some respects, this year's market action reminds us of the late '90s when technology, media and telecom were all the rage, and an enormous amount of capital was deployed to begin building out the internet infrastructure that we all depend on today for work, education, banking and life in general.

Investors, **then**, could not get enough of those type companies and often traded traditional valuation methods, like price-to- earnings, cash flow and discounted cash flow, etc. for new methods, like "number of clicks" and "eyeballs" (viewership). Those alternative valuation methods were seemingly "invented" to help investors justify ownership since many of the nouveaux companies had no free cash flow.

A significant amount of capital was raised during that period via IPOs which were supported by robust stories, visions, pitchbooks and business plans. Unfortunately, for unsuspecting investors, actual revenue levels for many of those, then, new companies turned out to be far less than forecasted, no meaningful amount of sustainable cash flow was ever produced, and a significant sum of capital was vaporized.

Today is **different**, versus that era, in that many of the large-cap technology companies involved with Artificial Intelligence ("AI") produce incredible sums of cash annually. What is seemingly **not different** today is the **embedded** enthusiasm reflected in the valuations of companies closest to the development and operationalization of AI. Market participants seem to have little doubt that AI will bring significant efficiencies to businesses, in time, including, but not limited to: driving sales, managing costs and

integrating compliance functions. However, a great company **can only be** a potentially great investment when shares are acquired at a discount to its intrinsic value. Receiving good value for each investment dollar deployed is paramount for long-term investment success, in our view.

U.S. Equities

Market concentration is something we have written about in the past and believe it is worth reiterating. At year-end, the top **seven** companies by market cap represented roughly **31%** of the S&P 500, the **highest** concentration level ever recorded and accounted for roughly **54%** of the indexes 2024 return, according to First Trust Advisors L.P. When looking beyond recent years, the **previous** concentration peak was 20% - 22% in the late '90s/early '00s. Given current concentration levels, comparing the S&P 500 to a diversified equity portfolio is analogous to comparing **apples and oranges**.

When large crowds (investor psychology) **perceive** that things can only get better for a specific sector, industry or company, jubilance can displace rational thinking, leading to an any-price-is-a-good-price mentality for shares of coveted companies. Of course, in the **near-term**, **anything** is possible – richly valued companies can become more expensive and cheaply valued companies can become cheaper. **However**, when looking over the horizon, five, seven, 10 years and beyond, the price paid relative to the value received can have a significant impact on compounded returns. We believe investing discipline is always important, but **especially** during euphoric periods driven by new and potentially transformative technologies which investors perceive will drive sustainable corporate profitability. Sustaining high revenue growth rates and wide margins over long periods of time can be a formidable undertaking. For example, of the **top seven** companies in the S&P 500 on December 31, **1999**, only **one** was still in the top seven on December 31, **2024**, based on data reviewed at visualcapitalist.com.

The number of mid- and small-cap companies meeting our criteria increased during 2024. For our strategies that call for individual mid- and small-cap companies, we increased exposure in those areas as we exited, through our lens, some fully valued large-cap holdings.

Fixed Income & Commodities

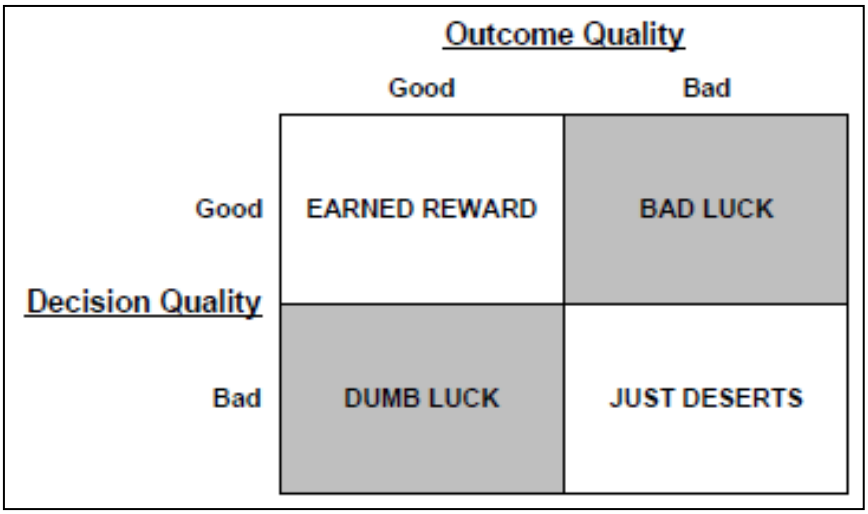
Corporate bonds' total returns, as measured by the ICE BofA U.S. Corporates 1-10 Yr. index, decreased 1.3% during the quarter, ending the year up 4.6%. U.S. Treasurys and Agencies, as measured by a similar index, decreased 1.6% for the quarter, bringing the 2024 return to 2.6%. Credit spreads (e.g., the difference in yield between a corporate bond and a U.S. Treasury of equal maturity) remained tight at year-end as economic optimism and favorable financial conditions prevailed.

Commodities, as measured by the Bloomberg Commodity Index, declined 1.6% for the quarter and was up 0.1% for the year. Oil (WTI) increased 5.2% for the quarter, bringing the 2024 return to 0.1%. U.S. oil production remained near record highs, mitigating OPEC+'s decision to delay increasing production from January to April 2025.

Risk vs. Uncertainty and the Decision-Making Process

In this **sixth and final piece,** we review the material covered over the last year and a half: **a)** Decision and Outcome Quality, **b)** the Differences Between Risk and Uncertainty, **c)** Types of Risk and Risk's Relationship with Returns, **d)** Uncertainty's Prevalence in Everyday Life and finally **e)** the concept of "Noise."

We began our series in the third quarter 2023 update, discussing the relationship between **Decision and Outcome quality**. In that piece, we discussed the concept of "**Resulting**" (or outcome bias) which occurs when people assign a decision-quality based on the outcome alone. This practice ignores luck's influence on everyday outcomes. To better illustrate luck's influence on decision and outcome quality, we borrow a chart from Annie Duke's book, *How to Decide*. We used Duke's example of going through a traffic light to demonstrate:



- Earned Reward – the light is green; you go through the light safely. Good decision – Good outcome.
- Dumb Luck – you run a red light, still get through safely. Bad decision – Good outcome.
- Bad Luck – the light is green, but someone else runs their red light and you get in an accident. Good decision – Bad outcome.
- Just Deserts – you run a red light and get in an accident. Bad decision- Bad outcome.

To maximize our "**Earned Rewards**," we rely on **margin of safety** as a part of the investment decision-making process. We believe finding companies trading at a discount to **intrinsic value** by analyzing fundamentals such as moats (competitive advantages), balance sheet strength, returns on invested capital and sustainability of earnings and free cash flow is paramount. Bad Luck outcomes can occasionally occur despite a time-tested process. We strive to mitigate Bad Luck by investing with a margin of safety. The wider the margin, the lower the probability Bad Luck results in a permanent loss of capital.

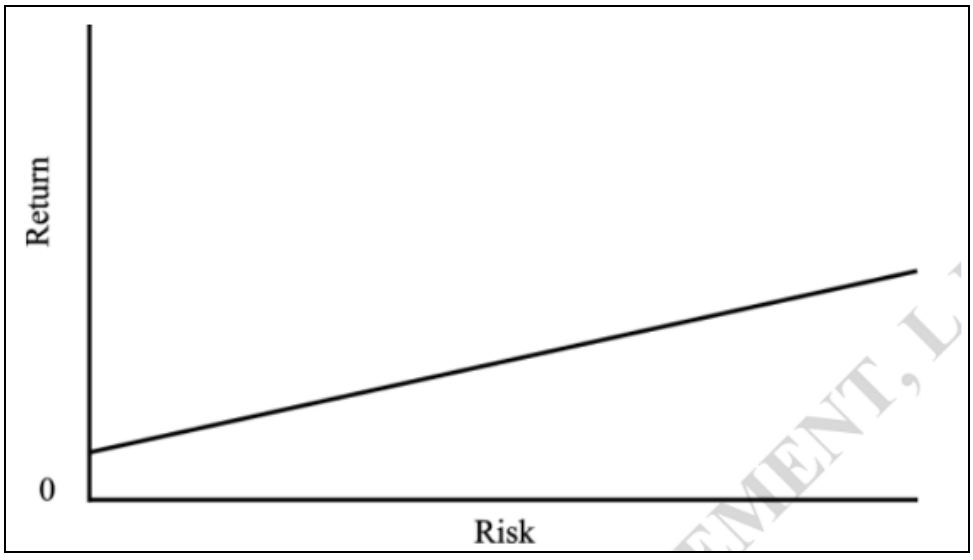
Our **second piece** discussed the **Differences Between Risk and Uncertainty** (2023 4Q). The two terms (Risk and Uncertainty) are often used interchangeably but have distinctions. Each refers to unknown outcomes; however, **Risk's** potential outcomes are known and the probabilities of those outcomes can be reasonably estimated. **Uncertainty** means all possible outcomes are not known or predictable and therefore cannot be estimated.

To illustrate Risk vs. Uncertainty, we consider a typical situation like picking up a friend from the airport. There is a **risk** that the flight is delayed, arriving hours later than expected. We know there is a chance this will happen and can assign a **probability** to the flight arriving late. The potential outcomes are knowable: the flight is either on time or delayed. Uncertainty is you are late to the airport because you got a flat tire. Who could have predicted such bad luck? We know there is a variety of wild circumstances that could have transpired to delay you, but we could not have reasonably predicted this outcome based on prior experiences.

Again, we require a margin of safety to help mitigate the risk of a permanent loss of capital due to both risk and uncertainty in the investment decision-making process. When possible, we quantify risks and apply them to our framework (e.g., earnings, cash flows, sales, etc.). However, uncertainty dominates decision making in business, investing and life. Although there are still unknowns, investing at a discount to intrinsic value (i.e. margin of safety), can reduce the likelihood of a permanent loss of capital and is more likely to produce "heads I win, tails I don't lose much" scenarios.

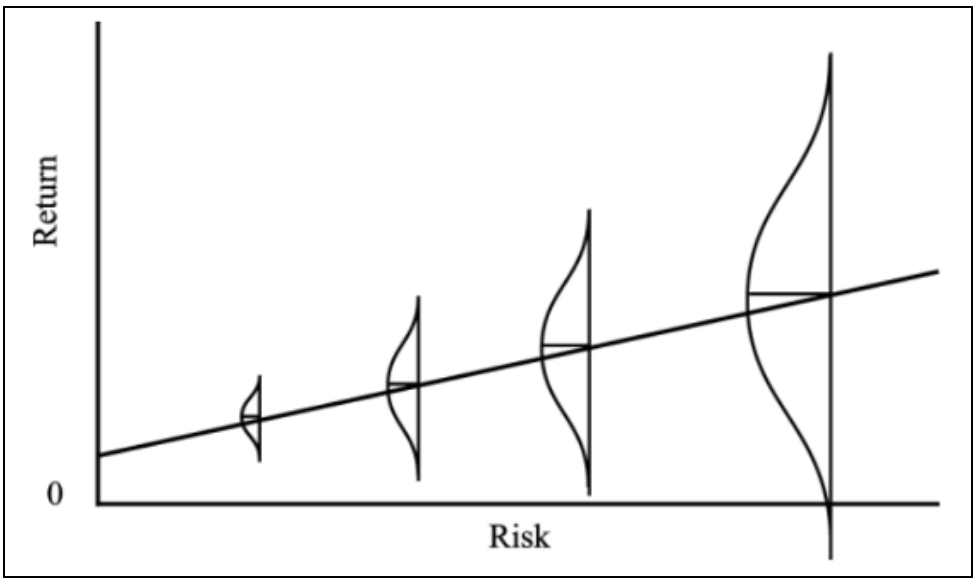
Next, we covered **Risk** (2024 1Q) in more detail (unknown outcomes with known probabilities of potential outcomes). We discussed the relationship between risk and return, as well as various types of risks to assess.

Risk assessment is an integral part of our investment decision-making process. Oftentimes the thought is – taking more risk is the way to achieve higher returns. Howard Marks is an investor and author whose work and thought process we respect. He is the co-founder of Oaktree Capital, famed credit investor and author of *The Most Important Thing.* Marks has discussed risk several times in his memos over the years. His illustration below highlights the **academic view** of risk and return:



The graph above leads you to believe more risk = more return. Why wouldn't anyone take more risk? We believe this is misleading; more risk means the **possibility** of higher returns. In light of the possibility and not the guarantee, we must recognize that the range of outcomes **widen** as risk is added (including

potential losses). Marks **better captures** the relationship of risk and return below, in our view.



The risks we described in our prior communication (2023 4Q) were not all inclusive. They often overlap and apply to investors, business and individuals alike. Risks include but are not limited to: permanent loss of capital, leverage, funding, interest rate, reinvestment, credit, concentration, over-diversification, underperformance, illiquidity, not taking enough risk, FOMO (fear of missing out), model, black swan, fundamental, valuation, correlation, loss of purchasing power and upside risk.

While it is important to monitor all these risks, we believe the risk of a permanent loss of capital is the most important one to consider in investing. Many other risks are contributors, but the risk of a permanent loss of capital is the primary one. We are not referring to short-term volatility and price fluctuations, but permanent impairment of capital.

Accepting risk is a part of investing; however, it is important for returns produced to be commensurate with the risk taken. More details on these risks can be found in our 2024 1Q letter at www.ebsinvests.com under the Education, Market Report section.

The **following quarter** we reviewed **Uncertainty** (2024 2Q) and its prevalence in everyday life, and humans' psychological relationship with it – while focusing on what doesn't change in an uncertain world.

People are typically uncomfortable with uncertainty. Predictable and knowable outcomes are generally preferred. When seemingly random events occur, prior assumptions are often ignored and a story is made up to justify events. This is referred to as Hindsight bias or "knew it all along bias," which is the tendency to perceive past events as more predictable than they were in actuality. This bias often leads to overconfidence in predicting future events. For this reason, forecasting has generally proven unreliable. No one can accurately and consistently predict future events. This is why we have little faith in economic, stock market, interest rate and company forecasts. They are data points to weigh, but numerous variables and outside events can shift assumptions, altering outcomes. We focus on business quality,

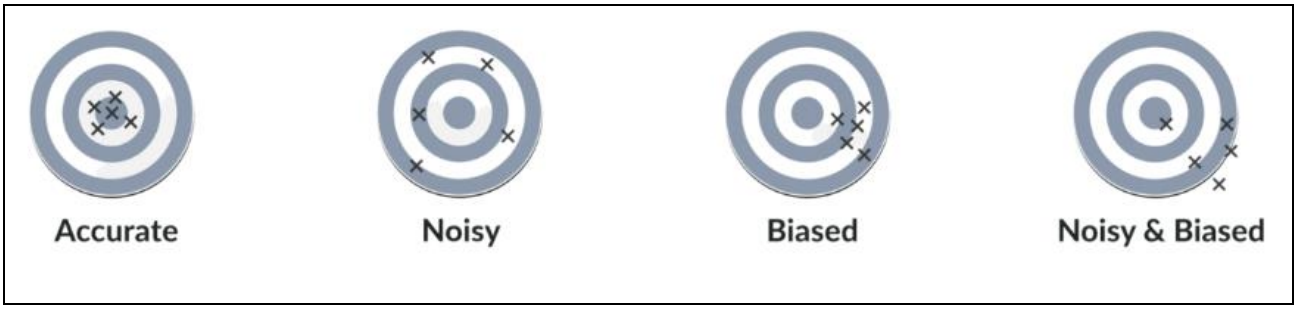
competitive advantages and margin of safety in our decision making, all of which should render short-term forecasts moot over time.

Uncertainty and change go hand in hand. Prognosticators focus on where things are going: the next big technology (e.g., AI, internet, electric vehicles, etc.), fads and trends. This makes sense, as humans want to know what the future holds and how to adapt. In an **ever-changing** world it can help to ask, "What do we expect to stay the same?" We recognize uncertainty is an important variable, but what can we reasonably predict will still be true in the future? No matter what the future holds, we can reasonably predict that food, shelter, transportation, technology and healthcare will still be needed down the road. In certain ways, these constants provide some margin of safety over the long-term. We must account for unknowable events (Uncertainty) in our investment decision-making, but recognizing what is likely to be true in the future should reduce uncertainty's impact on our long-term performance.

Last quarter, we discussed the concept of "**Noise**" (2024 3Q). Themes discussed below are drawn from the late Daniel Kahneman's book *Noise: A Flaw in Human Judgement*.

Kahneman starts his book by breaking down the two forms of human error: Noise and Bias. Noise is seemingly random and unknowable (much like uncertainty). Bias is more consistent and knowable.

The work **illustrates** Noise vs. Bias through four groups firing at a target (illustrated below; left to right). The **first** group was on target. The **second** group was erratic and noisy. The **third** group was biased towards the right side of the target. The **fourth** group showed bias and noise, shooting toward the right but in a wide array.



The **Noisy** group tells us how unpredictable the next shot will be. The **Accurate** and **Biased** targets both give us a good indication of where their next shots will land. But what causes divergent shots across the groups? The Accurate and Noisy targets can be distilled down to good and bad shooters, but what would lead all the shots in the Biased target to land so close? One explanation is that the gun is biased: it has a bent barrel, or its rear sight is too far to the right.

The illustration shows how Bias and Noise relate to Risk and Uncertainty. Bias and Risk represent outcomes that are **unknown** but **predictable**. Noise and Uncertainty exhibit **unknown** and **unpredictable** outcomes.

There are two types of noise (Level and Pattern). **Level** noise arises from an individual's error in judgement, while **Pattern** noise comes from specific factors. The example we gave was a judge ruling in

a court case. Level noise occurs when a specific judge is generally more lenient in sentencing compared to other judges. An instance of Pattern noise is a judge being more lenient on older criminals.

Noise permeates the markets and investing every day. Nobel winning economists can hold polar opposite points of view on any number of macro topics. "Experts" tout forecasts for GDP growth, sales, earnings and various headlines that are meant to grab your attention. As previously mentioned, we instead focus on long-term durability of companies and industries rather than fret about short-term issues. Near-term data are inputs into our analysis and decision making, but are only a small component compared to long-term competitive advantages and fundamentals.

In summary, weighing Risk and Uncertainty is a crucial component of our investment decision-making process. Risk can be reasonably measured, although outcomes are unknown, while uncertainty means potential outcomes and the probability of said outcomes are unknowable. Given outcomes are unknown, we typically require a margin of safety before making any investment. This means that even when bad luck and unforeseen circumstances appear, our chances of permanently losing capital should be lower than without a margin of safety.

Looking Ahead

As we peer into 2025, we believe the **range** of potential investment, economic and trade outcomes is **wider** than usual given the unknown magnitude of tariffs, the associated impact on economic growth and inflation, and the bevy of possible executive orders. A lighter regulatory touch will likely be welcomed by many industries, which can boost economic activity, and along with favorable economic and financial conditions, may serve as a catalyst for an increased level of M&A activity. A looming question is whether the earnings growth gap between the 10 largest stocks in the S&P 500 and the other 490 (+/-) will narrow in the year ahead. The nearly 40% gap as of November 2024 was the second widest since 1992 and only exceeded in late 2008, according to investment management firm Neuberger Berman. The prospects of lower income taxes and extension or permanence of expiring 2017 tax cuts should generally be a positive.

On the equity front, knowledge, reasonable diversification and conservative assumptions can be some of the best defenses in a concentrated and frothy market. On the fixed-income front, paying close attention to credits, spreads and duration are all important in a shifting landscape. We pledge to remain disciplined, as always, and look forward to the investment opportunities the year ahead may bring.

Past performance is not indicative of future results and all investments involve some degree of risk. Market and economic data have been provided by third party sources. This data, while believed to be reliable, has not been independently verified by EBS.