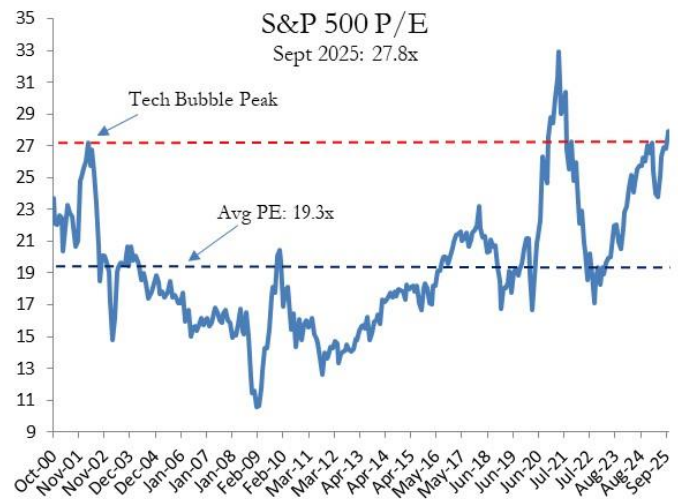


3Q2025

"Whatever you do, always give 100%. Unless you're donating blood."
Bill Murray

Investors seem to be giving 100% of their faith, and a large percentage of their balance sheet, to the notion that markets will continue to levitate higher regardless of valuation. Could too much of a good thing prove detrimental to those taking risks in the capital markets? Investors seem fully on board as continued gains tighten the tourniquet on those who opted to be defensively positioned over the first nine months of this year. The squeeze of underperformance as we enter the final quarter of what appears to be a very solid year of returns, will likely force many to take actions that are less than optimal from both a timing and valuation perspective to play catch-up.

Can returns and multiples continue to impress? Of course. As we all know, bullish markets don't end due to valuations alone. Uncertainty around markets and economies always drives speculation about the future. The conditions that exist today, however, are in a somewhat rare position. Indices continue to achieve new-high after new-high almost daily. Investors haven't witnessed a -2.0% daily pullback in the S&P 500 in over 128 trading days at the time of this writing. Yet despite this seemingly perfect picture, the Federal Reserve opted in September to begin what many believe will be a rate cutting cycle that could last well into 2026. Their concern for stagnant labor markets now appears to trump (I couldn't resist) their focus on a resurgence in inflation due to price pressures caused by the administration's tariffs.



Recent private-sector labor data reflects a meaningful pullback in hiring momentum. Job openings are declining, falling roughly 17 percent year-over-year, reaching their lowest levels in several years. The services sector, which comprises the vast majority of U.S. employment, has contracted for four straight months according to the Institute of Supply Management, signaling that the labor cooling is spreading beyond manufacturing into broad swaths of the economy. Add to this, the New York Fed's Survey of Consumer Expectations that shows households now believe job-finding prospects are at a series low, and expectations for rising job losses and higher unemployment have increased. Meanwhile, firms' hiring plans are at their weakest since the Great Recession, suggesting that employers are growing cautious about adding headcount in an uncertain environment. The question for the Fed is whether this is a temporary slowdown or something more serious. They've chosen to lower interest rates in an attempt to fan expansionary flames via business confidence and job creation. Time will tell if the gambit works and we avoid an inflationary response caused by added demand that may be choked by tariff costs and trade restrictions.

Artificial intelligence, and all that it promises, continues to compel investors to buy into the technology sector regardless of the costs, but perhaps more importantly, the potential for adequate returns. Consider the following. At the end of the 3rd quarter, the largest S&P 500 sector remains technology now representing nearly 35% of the overall index. The tech sector is over 2.5 times larger than the next biggest sector, financials, at 13.5% of the index. So what? This is nothing new, right? But consider the multiples that apply to these two sectors. Technology is valued at a consolidated trailing P/E multiply of nearly 43x while financials are valued at only 19.6x the last twelve months' earnings. Is a dollar earned in Palo Alto really worth over 2x more than a dollar earned by Wall Street's financial institutions? Maybe we don't really want an answer to that!

Perhaps more relevant is the Price-to-Sales multiple applied to the two largest sectors. This ratio helps investors understand how much they are paying for each dollar of a company's revenue. Sales, unlike earnings, are harder to manipulate through accounting. When this figure is extended it indicates investors' expectations for growth in the future may be at overly positive levels. Financials ended the quarter at an average P/S multiple of 2.9x while the Tech sector now sits at a very lofty 10.1x sales. The broader index now seems extended by all comparisons, amplified by the significant influence of its largest and most overvalued sector. The obvious comparison is with the heady days of the technology boom in the late 1990's and early 2000. For those of us who lived through that investment period it is hard to fathom we are back to a similar or perhaps more extreme position. The obvious example is the often-cited quote from then CEO, Scott McNealy, when referring to the Price-to Sales valuation of his business, Sun Microsystems, at the peak of the boom in 2000:



"At ten times revenues (sales), to give you a 10-year payback, I have to pay you 100% of revenues for 10 straight years in dividends. That assumes I can get that by my shareholders, that we have zero cost-of-goods-sold, zero expenses, no taxes, and I pay you all the revenues. That's not going to happen"

The S&P 500 witnessed a -49% decline from its peak in September 2000 to its bottom in October 2002 as the momentum-driven hype promising a new future burst in grand fashion. The similarities to today are notable. AI promises to change the scope and scale of information usage while displacing vast portions of the workforce. The costs to achieve all this are massive, both in dollars spent and energy used. The ROI on these expenditures are years away but valued as if they have infinite promise. No doubt a few companies will have success, but many are likely to succumb to the realities of a market that will move on to the next theme of great promise while redeeming their AI dollars for such an investment.

Despite the market strength, the smart folks at Goldman Sachs are sticking with their view that we are at the late stages of a super cycle that began with the recovery from the Great Financial crisis. Their equity team, if correct, may be a bit early to the party with this view but they believe the S&P 500 will generate only a 3% annualized total return during the next ten years. Their "Postmodern Cycle" is one where alpha will be more available than beta as stock selection becomes a more meaningful driver of returns over simply riding along with the broader market's generosity. Their view is that margins are elevated and interests rates have little room to fall from current levels. To be fair, we've heard this story before, but if accurate it will benefit those of us investing in companies that hold significant longer-term value relative to their stock price.

At the investment level, our Strategic Value portfolio returned 14.6% for the first nine months of the year versus an 11.6% return for our comparable benchmark, the Russell 1000 Value Index. Stock selection continues to be the primary driver of outperformance for our collection of businesses, especially considering our low exposure to the technology sector. There were several changes to the portfolio in the 3rd quarter. I liquidated our position in Federated Hermes (FHI), a provider of asset management products, after the company exceeded my long-term valuation target. Federated provided a return of over 60% from our initial purchase in 2023. I swapped our long-held position in LyondellBasell (LYB) in late August into a similar chemical manufacturer to harvest the loss we incurred as a result of the protracted decline in ethylene and propylene demand and pricing. I continue to believe the chemical manufacturers offer a very compelling risk/reward based on their ability to consistently generate meaningful cashflow. This thesis was recently supported by the Berkshire Hathaway acquisition of the

OxyChem business from Occidental Petroleum for \$9.5 billion. Even at 95 years old, Warren Buffet is still hunting for value!

Finally, I added two new positions in the portfolio that take somewhat of a barbell approach to market returns and the economy. The first is a consumer staple position in the food manufacturing and production vertical. This business trades at a 20-year low, generates a double-digit free cash flow yield, and could be the recipient of buyer interest from a rotation into staple stocks if the broader market performance begins to fade. The second position is a global staffing business that trades at recession level market multiples. This business is predominantly focused on the blue-collar workforce and should be much more immune to the fears surrounding AI and its impact on labor requirements. This business has a total yield of over 11% when combining dividends paid and stock repurchased in the last 12 months. I'm hopeful for the results we may witness with these businesses in the years ahead.

As always, I appreciate your trust and remain committed to navigating these uncertain times with discipline and a focus on long-term value. Please reach out if I can be of any assistance.

Drew
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