

Resilient... or Complacent?

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August 21, 2025

One of Warren Buffett's many famous quotes is to be fearful when others are greedy and greedy only when others are fearful. Underlying this investment truth is a recognition that markets don't move in a straight line. Instead, while the general direction may be higher (and has been for equity markets to the tune of 9% annually over the last 100 years), markets ebb and flow based on 1. Current fundamentals and 2. Expectations of future conditions.

Considering the first input, the current environment appears healthy. Unemployment remains low (4.2%), inflation is far lower than in recent years (though stubbornly above the Fed's 2% target), and Gross Domestic Product (GDP) grew 3% in the second quarter. Consumer credit is healthy and for the 60% of Americans who own their homes, there is a war chest of home equity north of \$10 trillion that has padded the homeowners balance sheet just since the pandemic began.

The outlook for the future environment is a more complicated assessment. By nearly all accounts the current administration has raised the level of uncertainty and volatility given the cascade of news flow related to tariffs and other policy changes. Beyond the daily announcements, tariffs will move from less than 3% of imports to somewhere perhaps north of the current 13-14% level, which raises the likelihood for higher prices, lower corporate margins or both. Longer term, it appears we are witnessing a shift in trade flow dynamics and the global balance of power which could change the course of the future in ways difficult to forecast.

Geopolitically, uncertainty abounds around the globe, which combined with continued domestic deficits, and a swelling federal debt clouds the sustainability of the current strong fundamentals into the future.

To state it simply, current fundamentals are strong, but there is also an above average level of uncertainty about the future. Without looking at the screen, one might expect to see blinking yellow lights in areas of the financial markets.

Surprisingly, this is not the case. Credit spreads between high quality fixed income securities (the 10-year U.S. Treasury bond) and lower quality (BBB rated corporate bonds with similar duration) have bounced off January lows but remain less than 50 bps higher than the lows over the past 40 years. The VIX, a measure of equity market volatility, again fell below 16 this week, near the low of the year and well below levels seen in other uncertain environments. Defensive stocks, as a percentage of the S&P 500 Index, are at 35-year lows. And the Goldman Sachs Non-Profitable Technology Index is up 15%+ YTD and has rocketed nearly 60% from the Liberation Day lows in April, consistent with near all-time highs for crypto and meme stocks, all as barometers for the prevailing risk-on sentiment.

All of these data points, along with the S&P 500 Index and the Nasdaq 100 Index both trading slightly off all-time highs, suggest that the market is unconcerned about future uncertainty. As Ed Hyman of Evercore ISI has pointed out for decades, every great bull market climbs a wall of worry. To be sure, the current wall seems rather high.

This leads us to a key question: are we witnessing a period of *resiliency or complacency*?

Our Take

To state it simply, we believe the answer to this question is yes and yes. Consumers and corporations have both come through challenging and variable periods in the past five years and currently have far healthier balance sheets than in prior cycles which argues for greater resiliency than in past cycles. Adding to this the potential for an easing rate cycle at home – in coordination with central bank easing that has already begun outside the U.S. – could create even more breathing room. On the flip side, some parts of the market – in speculative assets like a few of those mentioned above in particular – are showing signs of significant exuberance that smacks of complacency, which gives us pause.

As fundamental investors, we pay attention to the macro but spend our days looking for great companies run by talented people constructing a portfolio that compounds cash flow and earnings growth at a sustained and better than average rate over time, all at a reasonable valuation. We operate with this approach in every environment, but that doesn't diminish the importance of understanding the current environment and future expectations. Based on our discussions with company managements and our view of the world, we would share four relevant perspectives:

Tariffs are being managed. Our strategy focuses on owning leading companies that are dominant in their fields. This leads to some of the largest and most diversified supply chains in the world, allowing these companies to pivot the source of supply, the assortment in tariffed countries like the U.S., and find other ways to cut costs before passing the tariffs on through higher prices. In the near term, this could exert pressure on margins, but over time we see wider moats and greater share gains broadly, especially versus smaller peers that lack scale.

We are in the midst of a powerful tech transition. There is little question the developing digital and AI transformation is dawning a new era of efficiency, opportunity and disruption. There will be winners and losers, and we strive to capitalize on this with our holdings that benefit from the greater need for data, productivity gains from cost efficiency, and new opportunities that arise from tech and data-driven innovations and capabilities.

Valuations are on the high side, but opportunities still remain. Valuations are historically high in both absolute terms and relative to the current rate environment, in part as a result of the optimism related to the tech transition potential mentioned and the risk-on mentality mentioned above. This should elicit some pause. For us, we continue to find less exuberant names that still meet our quality and growth hurdles. We have had success going down the market capitalization scale and over the years have benefited from both upward revaluations and downside protection during drawdowns in these stocks.

The market remains narrow but the laws of mean reversion still exist. The SPX hit an all-time narrowness at the end of 2024 with only 10 companies representing nearly 40% of the market capitalization of the S&P 500 Index, and this has continued into 2025. Narrow markets (think Nifty Fifty) do not last forever. In the meantime, we believe there is significant risk investing in such a top-heavy market cap-weighted index especially given the valuations highlighted above.

Watch Your Step

In times like these, it pays to watch your step. This means to allocate more capital where conviction is strong and take care in constructing a portfolio of high-quality equity holdings which can compound earnings and cash flow at an above average rate over time. Few will see in advance the reason for the next drawdown in the broader market, but we will combine quality, growth and a disciplined valuation approach that will leave us in good stead when this happens, while compounding returns in the meantime as we have done since the founding of the firm.

HSMP Composite Performance (As of 6/30/2025)	YTD	1 Year	3 Years Annualized	5 Years Annualized	10 Years Annualized	Since Inception 4/1/07 Annualized	Since Inception 4/1/07 Cumulative
HSMP Composite (net-of-fees)	6.0%	16.2%	15.8%	13.2%	12.1%	11.9%	675.7%
S&P 500® Index	6.2%	15.2%	19.7%	16.6%	13.7%	10.6%	523.3%

Based on HSMP Concentrated Quality Growth Composite performance returns (net-of-fees) since inception 4/1/07 through 6/30/25 and includes the reinvestment of dividends and other earnings. Past performance is not indicative of future results. Please refer to pages 4-5 for important information.

Part of watching our step is to remain focused on the quality of the businesses we seek to own. Rather than mirroring index allocations, our strategy seeks out high-quality growth opportunities across the growth continuum — from dominant, durable and defensive companies to more rapid top-line and faster earnings growers. We have found asset light, take rate businesses in recent quarters that have significant white space to drive growth for many years to come. We have gone down the market capitalization scale and found the shares of companies that have seemingly been forgotten in a tech-driven world but continue to provide strong cash flows and trade at highly discounted prices. We have also participated in the oligopoly of providers that are enabling digital transformation and the use of AI to become widespread across industries and geographies. We believe the combination of the cash flows of these businesses puts upward pressure on the value of the portfolio in good times and bad and over time at a faster pace than the market average.

Watching our step also includes remaining especially vigilant about valuation, avoiding the temptation to adopt the promise that some companies can sustain rapid growth infinitum, justifying vaunted valuations...until they are not. We have seen this play out over and over and, while the details are never the same, each time is a shadow of the past. Rapid early growth, wide acceptance, extreme valuation, and then normalizing results that lead to a destruction of value, especially for the latter participants.

Despite the challenges that lay ahead, we remain optimistic about the U.S. as the hub for innovation and labor and capital formation. Tariffs, geopolitics, and other policy changes pose challenges but the dynamism of strong corporations drives these companies to evolve. The consumer remains relatively healthy, the labor force remains strong, unemployment is low, and consumer and corporate balance sheets are healthy. We are attuned to market complacency, and we believe there are some areas where this is concerning which we actively seek to avoid. At the same time, we appreciate our country's resilience and the ingenuity and tenacity of great companies run by highly capable management teams. We will continue to work to find and invest in these businesses to drive future performance for all our clients.

Thank you for your confidence and trust in our team.

Important Disclosures

All investment strategies have the potential for profit or loss. Different types of investments involve varying degrees of risk, and there can be no assurance that any specific investment will be suitable or profitable for a client's investment portfolio.

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which typically range anywhere from 5 to 100 shares depending on the stock price. While the investment merits of a given security drive our investment decisions, we use trading groups to facilitate trading and not all groups trade to the same extent. Client account holdings and performance can deviate from our Composite and/or from other client accounts, and also from the representative portfolio, for several reasons, such as: client restrictions, account type and size, timing and market conditions at an account's inception and contributions/withdrawals, timing and terms of trades, actual client investment advisory fees (or the lack thereof), and client directed brokerage/commission recapture instructions.

We typically build a concentrated portfolio with a hard cap on company names and with an aim to keeping clients' capital nearly fully invested. Our investment advice is limited to domestic and foreign equity securities of publicly traded companies. Client accounts generally hold 20-25 companies, although in some cases they may hold more or less names. We do not maintain limits on industry or sector weightings, and while we do limit portfolio positions by company, clients' portfolios are likely to be significantly concentrated by sector, industry and/or geography, among other factors (client accounts can typically have over 50% exposure to the consumer discretionary, consumer staples and/or technology sectors). Cash is not a major component of our investment strategy, and we tend to keep client accounts almost fully invested with less than 1% residual cash position after a trading day. Our portfolio has typically been invested in what are generally considered more established, large cap names (over traditionally growth companies and mid-small cap companies).

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