Fourth Quarter 2024 (January 2, 2025)

Post-election enthusiasm pushed the general equity market indexes to a strong finish in 2024. As we regularly remind our clients, emotions (positive or negative) impact markets in the short run, and fundamentals (business growth and valuation) drive long term results. We discuss the current market sentiment since the election. We identify two recent trends in Artificial Intelligence and how we think about the companies in our portfolio management process. The past ten years have been very good for investors with the general market indexes earning far above the long-term average, so we paint a picture of possibilities for the next decade, weaving in SEM's twenty-seven-year experience. Finally, we highlight some areas of exuberance outside equities that we will need to keep an eye on.

Post-Election Enthusiasm

Donald Trump's presidential win this time around, along with the Republican party carrying both houses of Congress, feels like the will of the people in a more resounding way than in 2016. While the 2024 margin of victory in the popular vote was slim, the outcome was received peacefully, and we seem to be a country ready to move forward. While Trump 2.0 will make mistakes (indeed he already has and one was corrected), if you're an American you want the administration to be successful.

Many people are enthused about the new energy and perspective of the Department of Government Efficiency (DOGE), which plans to cut federal spending and reduce the size of federal government and deficit. Floated by Elon Musk, Trump has agreed to engage Musk and Vivek Ramaswamy, a popular entrepreneur, to an advisory commission to remove regulation, reduce expenditures and increase government efficiency.

This time is distinctively different from Trump's election eight years ago when the top CEOs had mixed feelings at best. Today the top CEOs such as Jeff Bezos of Amazon are "very hopeful" about the new presidency and pilgrimages to visit Mar-a-Lago have increased. Positive thinking abounds at American corporations. In a mid-December survey of 300 public-company CEOs, 77% said they expect the economy will improve in the first half of 2025, up from 45% last year for 2024. On the other hand, nearly 80% of CEOs also expect inflation to pick up in their respective region. Today's high price levels are already a struggle for many Americans, and further price increases above 3% would compound those struggles.

Trump enthusiasm extends beyond business. Efforts to achieve a settlement in the Russia-Ukraine war have accelerated and developments in the Middle East including the fall of the Syrian President, Bashar al-Assad, support our national interests.

SEM and Artificial Intelligence

Artificial Intelligence (AI) took a leap forward in November 2022 with the launch of the first user-friendly tool from OpenAI called ChatGPT. Only 2 years into the technological race to provide products and solutions for businesses to help increase productivity, and create an edge or keep up with competitors, market observers are trying to determine if we are already at peak spending on chips, cloud computing and networking.

The latest updates on AI developments are mixed. In a recent *Wall Street Journal* report OpenAI's GPT 5, which is supposed to unlock new scientific discoveries and accomplish routine human tasks like booking a flight, is having issues. One issue is that it is running out of data to consume, and the public internet does not have enough. So, the concern here is whether improvements in AI are starting to plateau. In a positive report, AI's next leap will be "long-thinking," or models designed to take more time to think over the results they generate versus today's instantaneous responses. While we believe that demand and further progress of AI will ebb and flow, it is still early in its development and more discoveries lie ahead that should support productivity. Meanwhile, we will keep a close eye on our portfolio companies that serve customer needs in this space.

The **SEM-Disciplined Investment System (SEM-DIS)** invests in companies ranging from **Nvidia (NVDA)** serving the AI market to **Sherwin-Williams (SHW)**, a terrific coatings and paint supply company. Within our discipline each company is required to have a fortress balance sheet, earn high profits in relation to the capital required by the business, and generate excess cash beyond its core needs that piles up on the balance sheet or can be reinvested for further growth. We observe company data points as they surface and have 30+ years understanding that a company's competitive advantage and its customer needs evolve, nothing is static. In an investment industry that craves predictions, we don't pretend to tell anyone that we are *the* top expert on NVDA or SHW. The investment industry is built to tell you otherwise, that they are "*the"* experts, and in our experience this overconfidence can lead to ineffective portfolio decisions.

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The reality is that CEOs Jensen Huang (NVDA) and Heidi Petz (SHW) go to work each day, attempting to assess their customers' changing needs and working hard to innovate to keep their competitive advantages. It is SEM's responsibility to evaluate new business data points and take the appropriate portfolio management steps when a business shows signs of notable deterioration.

Decade Ahead

Looking back, it has been an incredible decade for investors, where the general market index, the S&P 500, posted an annual return of 13.1%, way above its long-term average. **SEM-Select Growth Portfolio** performed slightly above the most recent 10-year return for the S&P, which translates into a $1 million investment growing to an impressive $3.6 million after fees while an investment in the S&P 500 grew to $3.4 million (index fees absent).

SEM's goals over the long run are to outperform the relevant market indices while taking less risk, which it has achieved for each of its three equity growth strategies since their inception. While we are a bit disappointed with **SEM-Select Growth** only slightly ahead of the S&P 500 return during the last decade, we are still pleased with the very strong absolute returns noted above. The short story is the S&P 500 is now heavily weighted towards the most profitable and largest businesses in the world, many of which we also own. Over time this will evolve. SEM's since inception statistics, our upside/downside capture at 92%/75% respectively (as of the last available September 30th, 2024) tells the Suncoast Story. This statistic implies that on average if the market goes up/down 10%, SEM goes up 9.2% and down 7.5%. This is unique when compared to our growth manager peers, as most typically have both upside and downside capture ratios more than 100% showing much more volatility.

Importantly, since the last decade has been so strong let's paint a three-part scenario about what the next ten years could look like: (1) the stock market has another amazing decade of above average returns, (2) the market does what it's done since Suncoast's inception or (3) the market goes nowhere in 10 years.

As a backdrop, we looked at a graph dating back to 1937 to observe the S&P 500 10-year rolling average returns. We noted 7 calendar years (of course some were clustered together including those leading up to and ending in 1999) out of 86 calendar years where the 10-year annual rate of return exceeded the most recent 10 years of 13.1%. Alternatively, we observed 9 calendar years in which the 10-year annual rate of return was in a range of minus 1% to +2% annually, essentially flat.

Goldman Sachs and Vanguard respectfully and recently forecast the market will generate 3% annually over the next decade or in a range between 2.8% to 4.8%. Suncoast does not forecast stock market returns; we prefer to think in terms of 20 years in which the market has never experienced less than a 5% annualized return. So, of the three scenarios let's start with the worst. During a decade of no return, how has Suncoast done in the past? The table below shows the 10-year annualized return for the "lost decade" ending in 2008 and 2009. Dissatisfying returns for sure but SEM performed meaningfully better, 30%+ more than the market:

Year	SEM	S&P 500	Difference	SEM - 10 Year Growth of $ 1mm	S&P 500 - 10 Year Growth of $ 1mm
2008	2.64%	-1.38%	4.02%	$1,297,676	$870,262
2009	2.69%	-0.95%	3.64%	$1,304,012	$908,960

If SEM and the S&P 500 earn an annualized return similar to our since inception results of the past 27 years, that would generate very satisfying growth of $1 million to $2.71 and $2.34 million, respectively.

Time Period	SEM	S&P 500	Difference	SEM - 10 Year Growth of $ 1mm	S&P 500 - 10 Year Growth of $ 1mm
SEM Inception	10.48%	8.88%	1.60%	$2,709,172	$2,341,430

If the market has another decade of very strong returns that looked like the past ten:

Time Period	SEM	S&P 500	Difference	SEM - 10 Year Growth of $ 1mm	S&P 500 - 10 Year Growth of $ 1mm
10-Year end 2024	13.74%	13.10%	0.64%	$3,623,533	$3,424,728

We view back-to-back decades of above average returns as unlikely, though this is not a forecast and returns similar to our inception would be very satisfying. For the next decade to have good returns we will need the two most important influences on stock valuation to be favorable, robust earnings growth and generally low long-term interest rates, levels about the same as today or lower.

<u>Enthusiasm and Pockets of Excess</u>

The enthusiasm, which led to additional market gains in the fourth quarter, can get ahead of itself and ultimately be the trigger for a reversal in positive thinking.

While we believe the stock market has gotten a little ahead of itself, we observe some other areas of excess that seem more extreme and bear close watching. You can't make this stuff up; it is an incredible story. In November seven bidders competed for an "art" piece that went for $6.2 million and is merely an ordinary yellow banana affixed to a white wall with a diagonal piece of silver duct tape. Sotheby's, the auctioneer, marketed the fruit piece as a pinnacle of artistic achievement, on par with Andy Warhol's soup cans. The piece was titled "Comedian" by Italian artist Maurizio Cattelan, who according to *The Wall Street Journal*, is known as the art world's court jester since the 1990s and for creating pieces that satirize powerful and wealthy institutions. He first introduced this piece in 2019 in three editions and artist proofs that sold for between $120,000-$150,000, and comically when Cattelan saw the piece drawing huge crowds he tried to buy back one of the editions for four times the original price but had no luck. This reminds us of the story of the man who went into a barbershop and sat down for a haircut. As the barber was cutting his hair, all the people in the village ran by heading for higher ground. The barber asked the patron what was going on and the patron told him he spread a rumor that the village was going to flood at any moment. The patron and barber chuckled. A few minutes later as more villagers rushed to higher ground, the patron abruptly got up from his chair and headed for the door. He turned to the barber and said the story must be true. The moral is to be careful of the madness of crowds!

Back to the Comedian - Sotheby's estimated the November 2024 auction would fetch $1 million but the seven bidders chased it to $6.2 million and it sold to Chinese collector Justin Sun, founder of the cryptocurrency platform Tron, and he intends to pay for it in crypto. We believe this just about explains everything, as artwork only has an extrinsic <u>price</u>, not intrinsic <u>value</u>. Intrinsic value is determined based on the income of an asset such as a commercial rental property or the earnings of a publicly traded company. When informed investors decides to buy a commercial property or a public or private company, they assess the intrinsic <u>value</u> and compare it to the asking <u>price</u> of the seller.

Extrinsic items, such as art, Rolex watches, gold or crypto, do not generate any income or earnings so intrinsic value is undeterminable. In the public realm, an extrinsic item only has a <u>price</u>, whatever the buyer will pay. Bitcoin, the first cryptocurrency, hit a closing high exceeding $106,000 on December 17th, and then closed the year at $93,429. It has been quite a run from the beginning in 2009 to $64,000+ in November 2021, down to $16,000+ in December 2022, then to its record high this December.

This entire time we have never seen a report that estimates the value of Bitcoin. We don't have an opinion because we can't value it, but we can still urge caution. While those with a strong history of serving investors well such as Jamie Dimon and Warren Buffett have not changed their critical stance, others that are now in favor of it are some of the largest investment organizations in the world (that will go nameless but are obvious) that will benefit by earning fees selling cryptocurrency to the investing public.

Recently, *The Wall Street Journal* reported that Bitcoin's market capitalization is approximately $2 trillion and all cryptocurrencies combined total $4 trillion. Consequently, $4 trillion is no small sum and any significant trigger that sinks the price of crypto, like advances in quantum computing that could allow hackers to break bitcoin's encryption and drain digital wallets could create collateral damage. We don't know to what extent Bitcoin might be correlated to equities, but a Bitcoin collapse similar to the 75% decline in 2022 from its 2021 high, could bring down the spirits of the general investing public.

Final Thoughts heading in 2025

Consumer spending drives 70% of the U.S. economy, so how people feel about their jobs and their wallets is an important factor. The job market is still relatively strong, and inflation has come down, but prices remain high and home affordability is low. The sentiment is mostly positive about the actions President elect Trump is planning for his second term but completed actions speak louder than words. An extension of the Tax Cut and Jobs Act of 2017 is a high priority and the new Congress and administration have a chance to work together to pass the 2025 budget and reconciliation bill for the fiscal year ending September 2025. But they must work quickly as passage needs to happen in the next three months. Trump needs to have policies that support economic growth, reduce high costs and inflation, secure the border but actively welcome legal immigrants, build a modern military (drones versus jet fighters) all while calming and stabilizing the world and uniting Americans.

The stock market is a little ahead of itself but if earnings growth follows the post-election enthusiasm, then valuations may be justified. The ten-year U.S. Treasury yield is back up to 4.6% from the October low of 3.6% so will keep an eye on long-rates relative to equities. Of course, individual investment allocations should be customized and regularly reviewed.

We thank you for your continued confidence and we will keep working hard at it! Best wishes to all for a peaceful, productive and Happy New Year!

Sincerely,

Don	*Dan*	*Amy*
Donald R. Jowdy	Daniel T. McNichol	Amy A. Lord, CFA
CIO	President	SVP / Co-Portfolio Manager

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The Select Growth composite is an equity only composite employing the principles of Benjamin Graham & Warren Buffett. The discipline is a bottom-up fundamental approach and blends value and growth parameters. The portfolio consists of between 18-22 stocks.

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Beginning in June 2002, accounts that experience cash flows in excess of 10% of the account's market value are temporarily removed from the composite. These accounts are added back to the composite when they are considered fully invested. The minimum account value for inclusion in the composite is $100,000. Additional information regarding the treatment of significant cash flows is available upon request.

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