PARKSIDE INVESTMENTS

Year-End Market Commentary/Outlook

January 13, 2025

Dear Parkside Clients and Friends,

Equity market results in 2024 were similar to the market results in 2023. Returns of U.S. large cap stocks, as reflected by the S&P 500 Index, repeated their strong gains. Small cap stocks did not keep pace with large cap equities as investors continued to primarily concentrate their optimism on a shrinking subset of the largest U.S. equities. Non-U.S. stocks, which were particularly decimated in the fourth quarter due to concerns about potentially damaging trade wars in the coming year, lagged the S&P 500 in 2024 by 15%-20%.

We find it highly unlikely that 2025 (or the coming years) will reflect a repeat of the last two years (i.e., high absolute returns and significant U.S. large/mega-cap outperformance), mainly due to the starting point for valuations, as well as an inevitable change in the psychological dynamics existing today.

The U.S. stock market has increasingly become more concentrated in just a handful of names. While part of this is due to robust earnings produced by these mega-cap stocks, the price an investor is willing to pay for each dollar of earnings (the Price-Earnings ratio) has expanded at a much more rapid pace. For example, if one looks at Apple, investors were willing to pay 23x earning two years ago for these shares – a PE ratio that was historically in line with its average over the preceding 10 years. Today Apple's PE ratio is 33x, despite an expected earnings growth rate below the average company in the S&P 500. What justifies a nearly 50% increase in the PE multiple without any other corresponding meaningful change in its future growth? We believe Apple is a great company and have owned it for clients for years, but for a maturing company, which valuation makes more sense? Apple is not alone in this regard – we could list a number of companies where valuations have gone up meaningfully, but earnings growth rates are likely to decelerate.

Zooming out and taking the S&P 500 as a whole, the index trades at a PE ratio of 22x – more than 34% above its 20-year average. According to an analysis by JP Morgan Asset Management, when the S&P 500 has historically traded at this valuation level, the 10-year forward return has generally been between minus 2% and plus 2%. Market strategists and participants that still believe the market can post double-digit returns over the next decade resemble body contortionists trying to bend the basic principles of finance in order to justify unjustifiable PEs.

Our view is that the current market, and valuations in particular, is being less determined by economic fundamentals (earnings growth, cash flow generation, valuation) and more driven by several other factors (price momentum, money flows, fear of missing out "FOMO" speculation)

570 Lake Cook Road
Suite 100
Deerfield, IL 60015
312.778.7700 main
www.parksideinv.com

at a rate not seen since the "Nifty-Fifty" era of the 1960s or the end of the dotcom bubble of 1999-2000. We have addressed the influence of momentum and money flows previously, but what is particularly worrisome is the level of speculation permeating many assets today.

Speculation is not a bad thing. At its core, every investment relies on a level of speculation – hope for a gain but with a risk of loss. The problem is that in various time periods throughout history, a mindset overcomes some (or many) to pay little attention to the fundamental value of a security and instead focus purely on the price movements. During these times, investment time horizons shorten (i.e., want a big payoff now) and the concept of risk is viewed as "the risk of not making the most money" as opposed to "the risk of losing money". As you know, that is not our philosophy.

You only live once – commonly referred in today's vernacular as "YOLO". YOLO expresses the view that one should make the most of the present moment and not worry excessively about possible consequences (wording from Wikipedia – not always a reliable source of information, but in this case, we believe it sums it up well). We do worry (perhaps excessively) about consequences. We take seriously our duty to act responsibly with our clients' investments, and do not equate investment decisions to gambling.

Although we cannot deny that one only lives once, within the current financial market dynamics, YOLO reflects a growing philosophy that more resembles a gambling mentality. A number of factors have contributed to this phenomena, including: 1) COVID – the pandemic created an environment where people (particularly younger workers) stuck at home decided to pass their time day-trading in an environment where central banks and governments flooded the system with liquidity fueling a rapid rebound in asset prices despite challenging economics (thus enabling a perspective that fundamentals do not necessarily matter with investments), 2) periodic viral episodes of meme-trading frenzies, 3) a growing desire to be an influencer and post about big wins on social media (with complete silence when it comes to losses), 4) the advent and rising popularity of leveraged single stock ETFs that attempt to double or triple the returns of a single company's stock performance, and 5) the advent and rising popularity of short-dated call options – including options that expire at the end of each day – allowing participants to gamble smaller amounts on outcomes determined in days or hours.

Taking a flier worked for a while with tulips, as well as more recently with dot-com stocks and alternative cryptocurrencies/NFTs. This is not to say that Apple, or any of the other highly valued mega-cap companies driving the market are bubbles or frauds. Instead, they are, and perhaps will remain, great companies. However, their valuation levels are likely well beyond reasonable based on fundamentals. Furthermore, the paper wealth they have created has likely encouraged additional uneconomic speculation as investors seek to catch the next great growth idea.

PARKSIDE INVESTMENTS

Market Commentary
January 13, 2025

What does it say about the current "investment" environment when an alternative cryptocurrency named "Fartcoin" – created in October with apparently no meaningful economic purpose – has a market capitalization of more than $1 Billion – a valuation more than 50x higher than it was just two months ago?

Or what about a publicly traded company named Quantum Computing Inc., a penny stock a few months ago recently sporting a market cap of over $2 billion just because it has the trendy name "Quantum Computing"? Does it matter that it generates only $100,000 in revenue annually, or that it publicly disclosed its own management doubts the company's ability to continue as a going concern? Evidently not – what mattered was that the stock price started going up, so traders jumped aboard to push it higher.

Many other extreme examples exist. Again, the point is not that all "investments" are this detached from reality. In the dot-com bubble, for every legitimate Amazon.com that eventually recovered and thrived, countless others (Pets.com, TheGlobe.com to name just two) dissolved as their economics proved untenable. Rather, our view is that this rampant speculation has impacted many parts of the investment world, and that a reckoning – particularly for the extreme cases – will eventually come. What remains to be seen is both the timing and how widespread the fallout materializes. Will high PE stocks see their multiples contract to more normal levels? Will corporate margins in many sectors return to historical levels as demand growth subsides and/or competition catches up? Time will tell.

Despite the excesses discussed above, there remains a sizable portion of the investment world that are attractive long-term investments, generating strong and growing economic profits and trading at a meaningful discount to their intrinsic value.

Some of the intermediate and long-term trends that resonate with us include: 1) on-shoring and near-shoring of the manufacturing supply chain, 2) accelerating demand for low cost and accessible energy, and 3) a revival of mergers and acquisitions in undervalued companies to enhance shareholder value and compete globally. Many of these companies/industries may not currently be considered as trendy as the shiny object of the day, but they exhibit improving demand/supply characteristics that we expect will warrant greater appreciation as results continue to validate their attractiveness. These shifts may not occur overnight, but it is difficult to dispute that in time, these themes will be major forces for years to come. In the meantime, we will capitalize on the elevated prices of some of our holdings to reduce our risk, while reinvesting in more attractively priced securities or holding cash/short-term bonds and waiting for a more opportunistic investment environment.

PARKSIDE INVESTMENTS

Market Commentary
January 13, 2025

Although the backdrop for the market may present greater challenges than over the past few years, our discipline suggests a selective, diversified approach provides the best path to consistently navigate the upcoming challenges.

We welcome your comments and/or questions. Wishing you and your families a happy, healthy new year.

Sincerely,

Alan Cole
President
312.778.7705

Chris Engelman
Managing Director
312.778.7717

Disclosure: *The information contained in this message is intended to provide general information only and should not be construed as an offer of specifically tailored individualized advice or results. Clients or prospective clients should not assume that their performance will equal or exceed historical market results and/or averages. Past performance is not indicative of any specific investment or future results.*

Views regarding the economy, securities markets, or other specialized areas, like all predictors of future events, cannot be guaranteed to be accurate and may result in economic loss to the investor. All statements other than statements of historical fact are forward-looking statements (including words such as "believe," "estimate," "anticipate," "may," "will," "should," and "expect"). Although we believe that the expectations reflected in such forward-looking statements are reasonable, we can give no assurance that such expectations will prove to be correct. Various factors could cause actual results or performance to differ materially from those discussed in such forward-looking statements.