

INVESTMENT UPDATE

THIRD QUARTER 2025

As capital markets extend a remarkable but volatile streak of strong performance, we explore the headwinds and tailwinds being navigated by U.S. companies and explain how we are adjusting portfolios to find opportunity amid rapid change. We also share our perspective on recent developments in private equity.

A QUARTER OF STRONG RETURNS BUT GROWING UNCERTAINTY

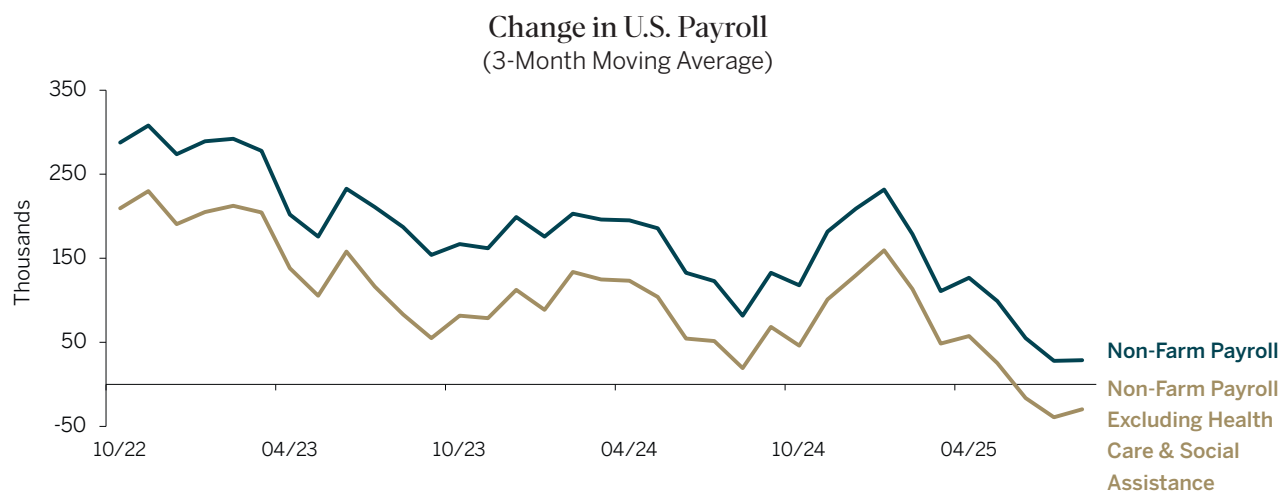
The U.S. equity markets continued to defy gravity in the third quarter of 2025. The S&P 500 delivered a total return of 8.1% in the quarter, bringing its year-to-date return to 14.8%. Non-U.S. equity markets were also strong, with the MSCI EAFE Index¹ generating a total return of 4.9% in the third quarter and an impressive 25.8% year to date.

During the third quarter, U.S. equities were buoyed by:

- Solid second-quarter earnings results, which exceeded lowered expectations
- The prospect of interest rate cuts, the first of which took place in September
- Easier financial conditions, due to higher stock prices and a continued slide in the U.S. dollar, which contributed to the earnings growth noted above
- Optimism about tax cuts and fiscal stimulus resulting from the One Big Beautiful Bill Act ("OBBBA")
- Continued torrential corporate spending on Artificial Intelligence ("AI") infrastructure around the country.

The Atlanta Fed's GDPNow model projects U.S. Gross Domestic Product ("GDP") growth was a strong 3.8% in the third quarter. Nonetheless, employment growth has decelerated sharply. Excluding the less economically sensitive health care sector, the three-month moving average in private payrolls *fell* by 30,000 in August.

Excluding Healthcare, Payrolls Are Falling



¹The MSCI EAFE Index is an equity index that captures large and mid-cap representation across 21 developed markets countries (Australia, Austria, Belgium, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the UK). The Index excludes the US and Canada.

How can we reconcile this unusual discrepancy between solid U.S. GDP growth and weak employment? By definition, GDP growth equals employment growth times productivity growth. Therefore one of three scenarios must unfold:

1. **A long-awaited productivity boom could develop.** AI or increased digital investment made during the pandemic could be contributing to economic growth without employment growth. This would be the best outcome for U.S. equities, because if continued, it could usher in a sustained disinflationary boom. However, surveys of companies using AI do not show this to be the case yet. A recent McKinsey poll found that, while almost 80% of companies are now using generative AI, the vast majority have not seen a bottom line benefit from it. Another study by researchers at MIT found that 95% of companies have seen no gains from their AI investments.
2. **Employment growth could catch up to GDP growth.** This scenario would have mixed implications for stocks. On the one hand, concerns about rising unemployment would fade. On the other hand, stronger demand for labor could push up wages, fueling inflation, which has remained stubbornly above the Fed's 2% target. Higher inflation could, in turn, keep the Fed from cutting rates as much as the market currently expects, disappointing investors.
3. **Employment growth could remain low and economic growth could slow.** Falling or flat demand for labor, coupled with nearly 3% inflation, would cause real income growth to be weak. With pandemic savings largely depleted, consumer loan delinquency rates up and home prices no longer rising, slow income growth could cause consumer spending to stumble, tipping the economy into recession. This would be the worst-case scenario for stocks. Given the widespread ownership of equities in the U.S., even a relatively small decline in equity prices could lead to a meaningful pullback in spending, thereby creating a negative feedback loop, in which lower equity prices lead to lower consumption, which then causes equity prices to fall further.

High valuations and widespread investor optimism lead us to believe that most people are betting on Scenario 1. We think the odds are greater that either Scenario 2 or 3 unfolds.

CAN U.S. CORPORATE EXCEPTIONALISM CONTINUE?

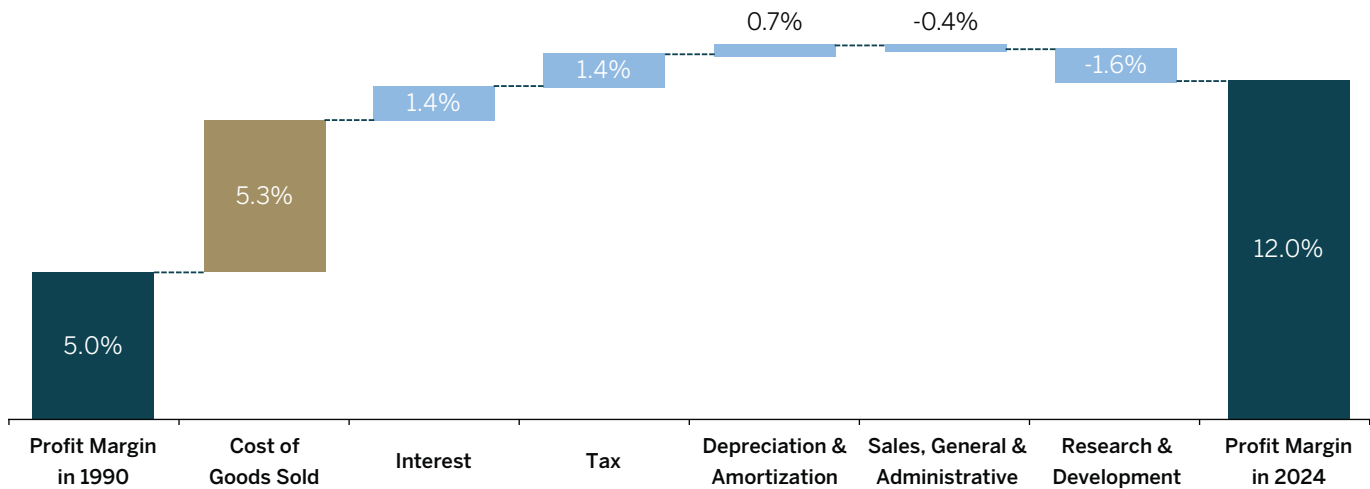
While the U.S. economy has grown faster than other high-income economies in recent decades, U.S. companies have increased their profitability even faster than economic growth alone would suggest. The magnitude of U.S. earnings growth has been integral to the record 25 years of U.S. equity market outperformance.

For global investors, determining whether U.S. outperformance can continue is of paramount importance, especially now, when U.S. policy changes may reduce some tailwinds that helped U.S. companies achieve these spectacular results.

Since 1990, several factors drove the exceptional margin expansion of U.S. companies.

Lower Production Costs Drove U.S. Margin Expansion

Contribution to S&P 500 Net Profit Margin Expansion Since 1990



Source: Goldman Sachs

While lower interest costs and taxes helped, the biggest contributor to margin expansion was the reduction in the cost of goods sold (“COGS”), an accounting term for the cost of production. A good deal of this cost reduction came from outsourcing labor- and resource-intensive operations to regions with lower costs of labor, energy and land. Access to a low-cost, global work force led to lower U.S. wage growth and allowed companies to produce and sell goods at lower prices. This contributed to significantly lower levels of inflation, which reduced interest rates and supported the lower levels of interest expense shown above.

Stricter labor laws, regulations and other policies in Europe and Japan prevented corporations based in those areas from globalizing operations to the same extent and kept domestic input and labor costs relatively high.

Can U.S. companies continue to grow margins at a faster rate than other developed markets? We see several tailwinds that may support continued margin improvement, but a larger set of headwinds that will make it hard for U.S. companies to repeat the profit improvements of the past.

Two tailwinds stand out. First, U.S. taxes will almost certainly come down. The average effective U.S. corporate tax rate is projected to fall to around 10% next year due to OBBBA provisions. Second, the Administration’s efforts to encourage capital spending, through accelerated depreciation, reduced environmental regulation and bank regulatory reform, could help companies boost profits.

However, it is unclear whether these efforts will be enough to offset several meaningful headwinds. First, interest costs for corporations are likely to rise in future years as debt issued when interest rates were extremely low matures and is refinanced at higher rates.

Second, and of greater significance, the Administration’s policies that are intended to bring manufacturing back to the U.S. will make further improvements in COGS difficult. Direct tariff costs and the slowing or reversal of

offshoring are likely to increase total production costs. Even if offshoring persists, wages are rising in China and other places where companies had moved operations, leaving fewer opportunities to cut costs by moving production abroad.

While the national security and supply chain resiliency benefits of domestic production are important, it is worth noting that in recent decades, Japan and Germany have not derived stronger economic growth or superior corporate profitability from policies supporting a large domestic manufacturing base.

It is possible that AI may begin to improve productivity and efficiency, boosting profitability, but we believe this is further in the future than many think. Our best guess is that management teams may be able to sustain current high margins but will have trouble expanding margins materially from this peak. If this is the case, investors are likely to be disappointed as sales growth alone is unlikely to meet the lofty earnings expectations embedded in current stock prices.

OUR INVESTMENT THEMES

Ironically, just when the U.S. appears to be taking a less laissez-faire approach to industrial policy, many other countries are moving in the opposite direction. Many of the policies outlined in Mario Draghi's recent report on European Union competitiveness are explicitly designed to improve European profit margins by reducing barriers to intra-European trade and by lowering input and borrowing costs.

We've discussed our *Opportunities Abound Abroad* theme in many of our recent *Investment Updates*. Non-U.S. equity markets have performed quite well this year, and valuations in many non-U.S. geographies still look very attractive at a time when U.S. equities are arguably priced for perfection. We continue to lean into this theme.

We have recently been adding to our *End of Disinflationary Tailwinds* theme. Fiscal and monetary policies in almost all major economies are loose, which should support consumption globally. And if we do get a productivity boost from AI or elsewhere, wealth will increase, and consumers will consume even more than they do today.

Relatively low oil prices have led to a significant reduction in capital investment by energy companies. After OPEC brings its current spare capacity online, most likely over the next 12-18 months, easily accessible energy reserves will decline dramatically. Investors are clearly not focused on this eventuality now, but we believe the lack of investment today will lead to meaningfully higher prices in the future. We're slowly beginning to position for this eventuality by increasing our energy sector holdings at a time when we believe these stocks are relatively cheap and unloved.

IN CONCLUSION

We find ourselves at a moment of unprecedented change and uncertainty, where there are a broad range of possible economic and market outcomes. The industrial policies of the U.S. and many other economies are becoming more mercantilist. Corporate investment in AI remains unabated despite limited commercial benefits thus far. We are navigating this moment with discipline, adjusting portfolios as opportunities emerge. We are also making sure to adhere to and continuously refine our time-tested approach to Thematic research and investing, which we believe will continue to serve clients well.

SIGNIFICANT PORTFOLIO ACTIONS IN THE SECOND QUARTER

Daiei Kankyo Co., Ltd.

During the third quarter, we initiated a position in Daiei Kankyo Co., Ltd., a leading Japanese waste management company, as part of our *Opportunities Abound Abroad* theme. Daiei Kankyo is a pure-play waste management company in a highly fragmented market. Waste management in Japan is still largely handled by municipalities that struggle to maintain facilities amid population declines. We believe the company is well positioned as a larger player in its market and will benefit from further M&A consolidation and continued privatization of the sector through public-private partnerships.

Williams Companies, Inc.

During the third quarter, we initiated a position in Williams Companies, Inc., a leader in natural gas infrastructure in the United States, as part of the *Balance* portion of our portfolio. Williams handles roughly one third of the nation's natural gas across its network of over 33 thousand miles of pipeline in 24 states. With natural gas demand increasing globally, an expanding need for reliable baseload power generation to support data center growth, and the need for dispatchable power generation to supplement growth in renewables, we believe William's primarily fee-based business is poised to benefit without as much underlying commodity exposure as other energy companies.

Kadant Inc.

During the third quarter, we exited our position in Kadant, Inc., a global supplier of technologies used in industrial processing, which was part of our *End of Disinflationary Tailwinds* theme. While we continue to believe Kadant is a well-run company with demonstrated pricing power and commanding exposure to attractive industrial end markets, the valuation has risen beyond our comfort level at this time.

Terreno Realty Corporation

During the third quarter, we exited our position in Terreno Realty Corporation, an industrial real estate owner and operator, which was part of the *Balance* portion of our portfolio. In recent quarters, we maintained Terreno as a small position due to its consistently rich valuation. Ultimately, given a moderating U.S. consumer environment and the size of the position, we closed this out to deploy funds elsewhere in the portfolio.

London Stock Exchange Group Plc

During the third quarter, we exited our position in London Stock Exchange Group Plc, a holding in our *Opportunities Abound Abroad* theme. Like other financial information service providers, LSE is facing investor concerns around increasing competition with rivals harnessing AI-based technologies. LSE has also suffered a decline in its core capital markets business as it deals with growing international competition and the loss of listings to larger and more liquid exchanges. We believe there are more attractive opportunities elsewhere.

BEWARE GREEKS BEARING GIFTS: THE “DEMOCRATIZATION” OF PRIVATE EQUITY

Private Equity (“PE”) funds have long been portrayed as the Rolls Royces of the investment world. With typical minimum investments of \$5 million or more, PE has been the exclusive preserve of ultra-wealthy families and the largest institutions. And rightly so. Few investors have the financial wherewithal and long investment horizon needed to accept the lack of liquidity, transparency and decision rights in this asset class.

But now, some of the biggest names in PE are throwing open their doors to anyone who can make a minimum investment of \$25,000 in a new class of retail-oriented funds, an effort trumpeted as “democratizing” PE.

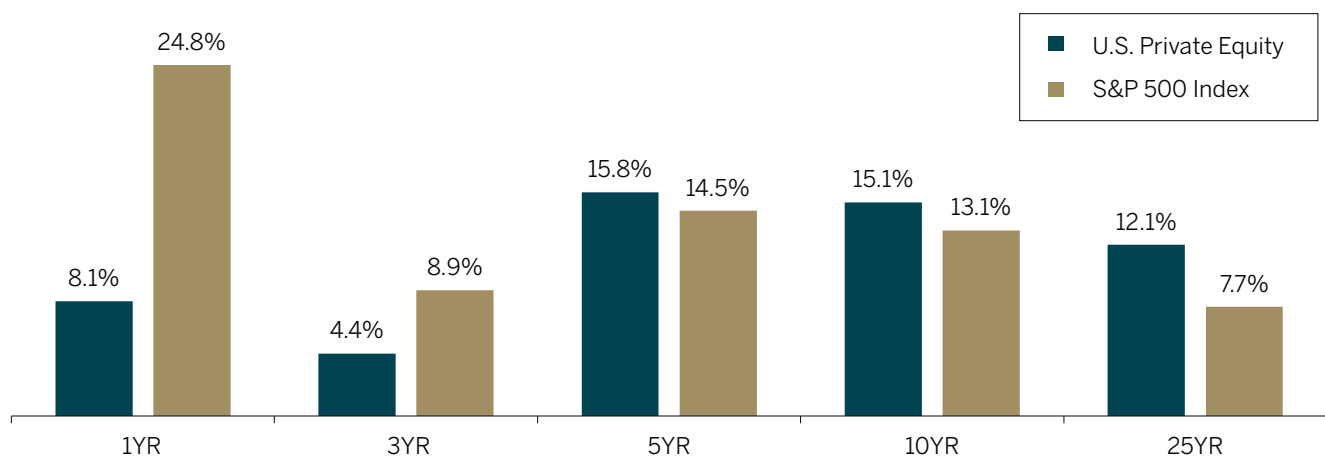
One can’t help thinking of the Greek army’s gift of a large wooden horse to the city of Troy in *The Aeneid*. PE managers aren’t welcoming the public into this asset class to be kind. They created these new retail funds in response to poor recent investment performance, lengthening periods of illiquidity and challenging fund manager economics.

DISAPPOINTING PERFORMANCE

Long-time investors are dissatisfied with recent PE returns and increasingly concerned that future returns may be no better. As of the end of 2024, PE as a category had underperformed the S&P 500 after fees over the one- and three-year periods and delivered returns close to public equity indices over the five- and ten-year periods. While PE did materially beat the S&P 500 over a 25-year period, most of that outperformance occurred in the early part of that long time span.

Most PE Outperformance Took Place More Than Ten Years Ago

Trailing Performance of U.S. Private Equity & U.S. Public Market Equities
(Period Ending December 31, 2024)



Note: Returns for private equities shown after fees.
Source: Cambridge Associates, Bloomberg

What went wrong? As is often the case on Wall Street, early success led to too much money chasing too few opportunities. PE emerged as a small but prominent asset class in the 1980s. Functioning basically as leveraged value investors, PE funds used debt to buy controlling interests in companies at low prices, with the goal of selling them at much higher prices after improving operations or breaking them up to capture the value of their parts.

Despite some spectacular failures – most notably KKR's \$25 billion buyout of RJR Nabisco in 1989, which lost roughly \$730 million over 15 years – many early PE investments generated hefty returns. The success of early adopters, such as the Yale University endowment, attracted other institutional investors, leading to an explosion in PE assets under management. PE grew from roughly \$600 billion in 2000 to almost \$10 trillion in 2024, with another \$2 trillion in contractually committed capital.

PE is no longer a niche, nimble asset class, and it becomes much harder to earn a high return on investment after the amount of capital to invest increases more than 15-fold.

To deploy ever greater pools of capital, PE firms have been forced to do bigger deals. In 2009, only 4% of PE deals in North America were valued at greater than \$1 billion. In 2024, \$1 billion-plus deals accounted for 22% of transactions.

The pressure to invest has also driven up valuations at purchase. In 2009, PE firms were buying companies at average multiples that were 40% below multiples for comparable public equities. That discount has narrowed over the past three years to less than 5%.

In late September, a consortium led by Silver Lake and Saudi Arabia's Public Investment Fund announced the \$55 billion purchase of Electronic Arts ("EA"), a video game maker, setting a record for the largest PE transaction ever. The purchase price represents a 25% premium to EA's closing share price on NASDAQ the day before deal talks were reported by *The Wall Street Journal*.

Complicating matters further, the increased cost of debt to fund purchases is not just an additional drag on investment returns. Higher debt levels increase the risk of portfolio company bankruptcy at times of economic stress.

LIQUIDITY PRESSURES

Institutional investors in PE are facing a liquidity crunch due to a three-year-long drought in distributions. With the decline in M&A activity and initial public offerings in recent years, PE funds have struggled to exit investments. On average, they are holding investments longer. These longer holding periods both lower annualized returns and delay distributions to investors.

For endowments, the liquidity strain is particularly difficult to tolerate. Many universities and other entities now face uncertain government funding, increased tax exposure and challenging enrollment and tuition trends. As a result, many are now selling some of their private equity stakes at a discount in the secondary market to gain liquidity. Secondary market activity has nearly tripled in value over the past four years.

MANAGERS NEED ASSET GROWTH

Traditional PE fundraising has declined in each of the past three years, limiting the growth in assets under management. Without ample new capital, PE funds may not have the revenue growth needed to support current investments and attract, retain and compensate the investment professionals and operating partners they need to identify new investment targets and create value in portfolio companies.

NOW ENTER “DEMOCRATIZATION”

That’s where “democratization” and the new retail funds come in. Wall Street is looking for a new revenue stream, using the elite reputations of PE managers to sell PE retail funds to the masses. PE managers, in turn, are seeking to grow assets under management, revenues and profits. And legacy PE investors are hoping to gain the liquidity they need by selling old investments to these new retail funds.

While we believe that many PE investors stand to make money in the coming decades, outsized returns are likely to be far harder to come by than in the early days of the asset class. Only those clients that can handle prolonged periods of illiquidity and tolerate the category’s opacity and lack of control should delve into PE investing. And perhaps more than ever, careful manager and vehicle selection will be key to avoiding the modern financial equivalent of a Trojan Horse.

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