January 6, 2025

Dear Clients and Friends:

A sense of calm enveloped financial markets in the U.S as the year ended. Economic growth continued unabated as GDP rose more than 2.7% while unemployment remained low.[1] Inflation seemed contained at roughly 3.0%, down sharply from its level two years earlier.[2] Oil traded unchanged for the decade, even as gold and other commodities rallied. Powered higher by the seven most popular stocks – with an average return of 60% and P/E multiples approaching 50x – the S&P 500 recorded a second year of strong gains even as the Fed Funds rate ended the year above 4.3%, ahead of inflation.[3]

Meanwhile, a Republican president, rising improbably from political exile, won re-election in a landslide. Following a chaotic withdrawal of the last ground forces from America's longest war, long-simmering tensions with Moscow hardened into threats of nuclear conflict. The Middle East was on edge with regional powers and proxy militia at, or close to, outright war with Israel. A bloody civil war raged in Sudan, Africa's third largest country. Eyeing a new trade and economic relationship with China and its leader-for-life, the incoming administration turned its attention to Beijing.

The year was 1972.

"So we beat on, boats against the current, borne back ceaselessly into the past." F. Scott Fitzgerald, *The Great Gatsby*

Economic historians have an undistinguished record as market forecasters but the parallels between 1972 and 2024 are striking. It is therefore worth noting that 1972-82 was a poor decade in which to invest in U.S. stocks. Claims that inflation had been tamed proved illusory as prices began to climb in 1973, amplified by an OPEC-led oil price spike, dovish monetary policy by the Federal Reserve and deficit spending to fund the Vietnam War. A deep recession ensued, and the stock market languished as the so-called "Nifty 50" stocks, analogous to today's "Magnificent 7" technology stocks, ran out of steam.

There were of course strategies that did well. Gold and other commodities surged in value as inflation conspired with anemic economic growth to weigh on financial assets. Among stocks, companies that disrupted industries, such as Walmart and Southwest Airlines, were standouts. Apple, famously founded in a garage in 1976 by Steve Jobs and Steve Wozniak, introduced the Apple I and II before going public in 1980. But investors in U.S. stocks who lacked the vision or good fortune to invest in these innovators experienced dismal returns: excluding dividends, the S&P 500 returned less than 2.0% annualized for the decade - and didn't recover its 1972 level in real terms until 1990.[4]

Are today's investors doomed to repeat the experience of the 1970s generation? As then, valuations are elevated, and the market's ascent has been driven by a small number of stocks. The so-called Buffett indicator, a ratio of the Wilshire 5000 market capitalization to GDP, suggests stocks are broadly over-valued, and the forward P/E of 22.0x for the S&P 500 is above its 10-year average of 18.5x and near previous highs in 1999 and 2008.[5] This

[1] Bloomberg
[2] Bloomberg
[3] Bloomberg
[4] Bloomberg
[5] Bloomberg

optimism for stocks occurs as the financial profile for the U.S. is weakening. Fueled by deficit spending, total Treasury debt outstanding is $36.2 trillion, representing 123% of GDP based on estimates by the U.S. Bureau of Economic Analysis and well above its long-term average of roughly 70%.[6] Net interest expense on Treasury debt is projected to be the third-largest outlay in the 2025 federal budget, exceeding defense. To date, an accommodating bond market has funded this profligacy without driving interest rates significantly skyward; however, we expect long term rates to remain elevated even if the Fed continues its easing program.

High valuations and unconstrained deficit spending suggest that, from current levels, returns for the S&P 500 are likely to be modest. Whether stocks will enter a bear market or tread water while earnings rise is unknowable but either outcome seems plausible. Meanwhile, the margin of safety for today's investors in the S&P 500 is thin, and we are seeking opportunities among less widely owned securities.

"Kites rise highest against the wind, not with it." Winston Churchill

A subdued outlook for the S&P 500 does not mean investors should abandon stocks. To the contrary, opportunities abound in companies outside the mega cap stocks that count so heavily in the index's total return. Technological innovations, including artificial intelligence, seem likely to accelerate productivity gains across the economy. Fracking and the development of alternative energy sources make an oil price shock less likely today, and with less destructive economic power, than fifty years ago. Our investments in **UBER** and **Texas Pacific Land Co.** reflect our positive outlook for wide-moated companies leveraged to these themes. We also note that monetary policy is more robust and flexible in balancing employment and price stability – and in the current tightening cycle, the Fed seems to have contained inflation without triggering a recession. Valuations of many mid-cap companies are undemanding.

Among the most attractively priced securities in our portfolio are the common stocks of non-U.S. companies, including **Nestle**, **Cie Financiere Richemont** and **Canadian National Railway**. Low valuations and mediocre recent stock price performance obscure the intrinsic value we see in each company. Consider Nestle, with leading market shares in health, nutrition and pet food, and unrivaled distribution strength in the world's largest and fastest growing regions. Spanning the globe with operations in 190 countries, Nestle has over 30 brands that generate more than $1 billion in annual revenue and owns 20% of global cosmetics company L'Oreal.[7] A newly appointed CEO has a mandate to increase investment in R&D and marketing and to rationalize the company's brand portfolio, all of which should translate into higher earnings and returns on equity above 35%. Meanwhile, the shares trade at 16x earnings with a 4.0% dividend yield – at the lower and upper ends, respectively, of their historical range.[8]

Valuation, however, is not the only reason to invest in companies with international operations. At a moment when many investors are focused on the collapse of global supply chains and a breakdown in the rules-based trading system that prevailed for much of the past century, we see a bright future for companies to gain market share in the fastest growing countries. As context, it is worth remembering that the U.S. and Europe together account for roughly one-eighth of the world's population and 75% of its market capitalization – an imbalance that will be hard to sustain without aggressive private sector investment in global markets.[9] Cracks emerging in the economic models promulgated by Russia and China, among the leaders of the BRICs bloc of developing countries formed

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[6] U.S. Bureau of Economic Analysis
[7] Bloomberg, Company Filings
[8] Bloomberg
[9] Bloomberg

as an alternative to the G7, make such an opportunity timely. Both countries face harrowing demographic and economic challenges, and what remains of a private sector operates under authoritarian political systems that seem increasingly feckless and ill equipped for the global reach and consumption-driven growth both countries desire. Opportunity awaits companies that can offer the largest generation of consumers the world has ever known a better path to rising living standards.

“If you don’t believe in value investing, what do you believe in?” Warren Buffett

In managing our clients’ capital, we seek a margin of safety in common stocks which we define as intrinsic value that exceeds the market price. Paraphrasing Warren Buffett, we look to the investment itself to determine value, not to whether an investment is popular or the hope that someone else will pay more. Some have asked whether the election of Donald Trump fundamentally changes the outlook for stocks, either positively (deregulation, tax cuts) or negatively (tariffs, deficit spending). Absent a revolutionary pivot in economic policy, we do not believe so. To be sure, we face geopolitical and macroeconomic challenges; however, trading around these risks is nearly impossible. The temptation to alter one’s investments in response to political events is a powerful force but we believe our disciplined, fundamental value approach is more effective at growing and preserving capital than the thematic, activity-intensive strategies promoted by our competitors.

As we turn the page from 2024, our 25th year as a firm, we thank our clients and friends for their support. With assets under management approaching $6 billion, Douglass Winthrop Advisors has the scale and resources to invest toward our goal of being the best independent firm serving families, trusts and endowments. Core to this vision is excellence in portfolio and wealth management, and a business model grounded in serving as our clients’ primary trusted financial advisor. To this end we are continually adding depth and experience to our team, ensuring our clients have a relationship with the firm, not solely a portfolio manager. Last year we welcomed Advait Prasad as an associate in our New York office and, in the weeks ahead will launch a new secure portal, which our clients can use to access quarterly reports and related documents in digital form. Meanwhile, as a snowy January begins, all of us send you our best wishes for a peaceful and prosperous 2025.

Douglass Winthrop Advisors LLC

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