VERMEER PARTNERS

THOUGHTS ON 2024

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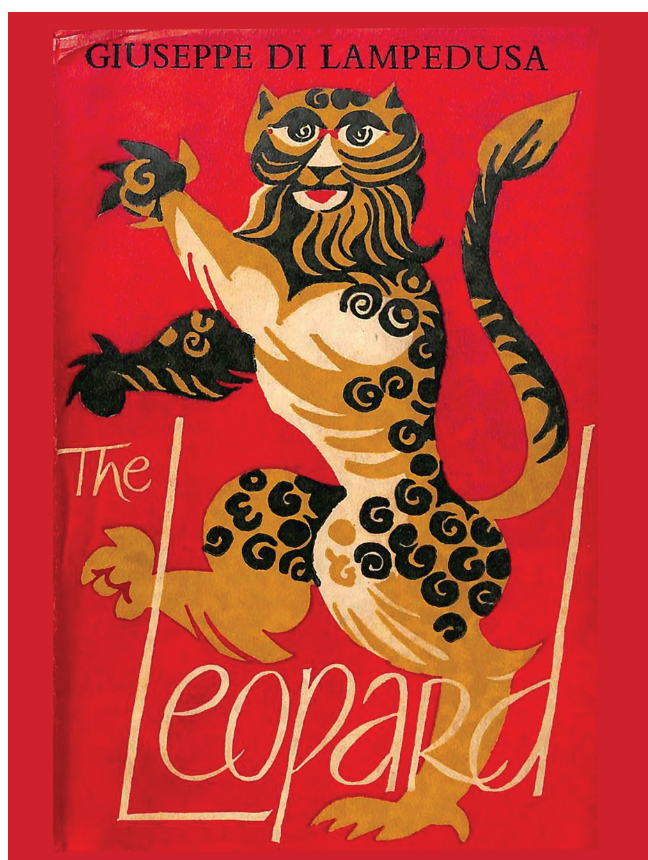
YFS VP PORTFOLIO FUNDS - OVERVIEW

WILLIAM BUCKHURST
INVESTMENT DIRECTOR



Over the last year, the Vermeer Partners Portfolio Fund returned +3.70% and the Growth Portfolio Fund (which has a higher equity content and, therefore, higher risk profile) returned +4.05%. The estimates for the ARC GBP Steady Growth PCI were +8.40% and the ARC GBP Equity Risk PCI +9.80%.

Since launch (16th October 2023), the Portfolio Fund has returned +8.57% while the Growth Portfolio Fund has returned +8.63%. The estimates for the ARC GBP Steady Growth PCI were +14.56% and the ARC GBP Equity Risk PCI +16.98%.

> "EVERYTHING MUST CHANGE SO THAT EVERYTHING CAN STAY THE SAME."
>
> The Leopard,
> Giuseppe Tomasi di Lampedusa, 1958

While Tancredi, nephew of the Prince of Salina aka 'The Leopard', is talking about the dying Italian aristocracy threatened by Garibaldi's approaching forces of democracy, this memorable literary quote lends itself well to last year's stock market. A lot of things changed over 2024: the inflation monster (albeit not dead yet) dissipated; most central banks started to cut rates; new governments rose, while old governments fell; the Chinese economy – for so long the powerhouse of global growth – continued to slow; and geopolitical tensions, especially in the Middle East, escalated. Yet one thing stayed the same: US equities followed the script of previous years – they shrugged off the noise and continued to march higher, with large technology companies at the helm.

The US economy – in stark contrast to many other parts of the world, especially here in the UK and mainland Europe – remains on a solid growth trajectory. Despite high interest rates (there were fewer rate cuts than expected) and gradually rising unemployment, the US defied many of the recession predictions from economists and strategists this time last year and grew by around 3% over 2024, on the back of 2.9% growth in 2023. It turns out that higher interest rates have not done much to disrupt economic activity, particularly when many mortgage holders locked in low interest rates during the pandemic years. And the less regulated "shadow-banking" system, including private equity firms, may have helped to buffer the impact of central bank tightening by providing alternative, cheaper sources of financing to businesses. Moreover, wealth has become increasingly concentrated in large corporates and affluent households, who tend to hold higher levels of cash, meaning that higher interest rates may have turned out to be a net positive for many.

Despite the big retailers, with the exception of **Walmart**, steadily issuing warnings of weaker consumer behaviour, the so-called "K" shaped recovery (a two-tier economy where high-income consumers bounce back quicker than those at the lower end of the income scale) has resulted in overall consumer spending remaining strong. This has been in spite of signs of weakness under the surface, such as a recent increase in car loan and credit card defaults.

Another fillip for markets has been the ever-growing excitement surrounding Artificial Intelligence (AI). This didn't just benefit technology companies: FactSet Document Search shows that over 200 of the S&P's 500 companies mentioned AI at least once or more on their quarterly earnings calls last year. Other sectors benefited too: even utilities, the worst performing sector in 2023, rebounded strongly in 2024 as data centres boosted demand for energy. Providers like **Vistra** and **GE Vernova** were the number two and number four best performing stocks in the S&P 500 last year. But while the demand for investment dollars to build the scaffolding for the AI revolution continues to grow, the risk remains that many investments within the AI-chain may follow the path of other technology-related bubbles. The Gartner Hype Cycle describes the inflated peaks that tend to precede a deep trough of disillusionment before main-stream adoption, and actual profitability, takes off. We continue to invest in companies at the forefront of the digital revolution, but advocate some caution where, in many cases, higher valuations might require some pretty heroic future growth assumptions to justify holding them. It follows that any set-back in markets could provide opportunities to acquire long-term winners at more appetizing prices.

"ANOTHER FILLIP FOR MARKETS HAS BEEN THE EVER-GROWING EXCITEMENT SURROUNDING ARTIFICIAL INTELLIGENCE (AI). THIS DIDN'T JUST BENEFIT TECHNOLOGY COMPANIES: FACTSET DOCUMENT SEARCH SHOWS THAT OVER 200 OF THE S&P'S 500 COMPANIES MENTIONED AI AT LEAST ONCE OR MORE ON THEIR QUARTERLY EARNINGS CALLS LAST YEAR."

2024 was also a year of political surprises. Donald Trump secured an historic comeback which made him the first convicted felon to win the keys to the White House. By not just winning the Electoral College, but the popular vote too, he effectively now has at least two years to set the agenda. He has already said that he is going to impose tariffs on China and other countries. While some of this may be rhetoric, whatever is enacted will have an impact on the price of those goods. A second Trump administration is also likely to want to continue its policy of cutting taxes, which is helpful for the growth narrative. He has also talked in the past, and more recently during his campaign, about possibly even

lowering the main rate of corporate tax from 21% to 15% for companies that make their products in the US.

Tax cuts are good for the growth agenda, but the budget deficit in the US is already over 6% of GDP. The market could at some point get a little bit nervous that those budget deficits are more likely to be going up than down under a Trump administration. The tariffs, which are only a small revenue generator, are about the only offset that he has come up with so far to his tax cutting agenda. If there is also nervousness about what tariffs are going to do to inflation, bond markets are not going to roll-over. We saw the Federal Reserve talk down the prospect of more than two rate cuts over 2025 and the yield on the ten-year Treasury hit 4.60% by the end of the year – its highest in over six months, despite 100bps of rate cuts since September. We highlight stickier levels of inflation and less supportive monetary policy as a particular risk over 2025. The year ended with hawkish comments from Jay Powell, Governor of the Federal Reserve, and a core CPI print at 3.3%, still stubbornly high.

But as mentioned, one thing stayed the same: the S&P 500 index shrugged off the noise and notched up another year of 20%+ returns, the fourth year out of the last six that this has happened. America's outperformance versus all other parts of the world has almost become a given. So perhaps it is worth reminding ourselves at this stage that, after a few years of stellar performance, there are a number of reasons why now might not be the best time to go "all-in" on US equities:

1. **Valuations in the US are now uncomfortably high. The forward price to earnings ratio is around 23x – close to the highest in its history, and the cyclically adjusted ratio (a measure developed by Robert Shiller of Yale University to smooth out the last 10 years of earnings) is currently in the high 30s. Both measures are expensive even when factoring in analysts' expectations of around 10% earnings growth for 2025.**

2. **Outside the US, valuations are reasonable, with Asian and European equity markets trading a shade above their historic averages.**

3. **Concentration in the US market has reached a record high. US equities now account for around 70% of global equity benchmark indices, up from around 30% thirty years ago. Large technology stocks – often referred to as the "Magnificent Seven" – now make up a similar weight in some global indices than the next seven biggest countries combined.**

4. **While earnings growth for the Magnificent Seven outpaced the broader market by 37% in 2023, this earnings gap narrowed throughout 2024 and consensus estimates expect it to decline to just 7% in 2025. Yet the valuation differential between these market leaders and the rest remains uncomfortably wide.**

5. **American stock ownership is back at an all-time high. Data from the US Federal Reserve shows that the percentage of households with share portfolios is back at pre-2008 levels.**

The relentless march towards passive investment only serves to amplify these trends – the more money that flows into the market, the more the largest index constituents are pushed higher. When stocks are being bought without any thought to the prices being paid, the likelihood of a sudden and dramatic reversal increases.

Here in the UK, valuations look more palatable. A new Labour government came as little surprise, but the timing was – a snap-election in July caught many off guard but means that we now have a reasonable level of time to judge the new administration on its progress and early reports are not encouraging. Growth is anaemic (GDP flatlined in the third quarter and is not expected to be any better this quarter), while the inflation rate remains uncomfortably high (core inflation was at 3.5% in November, up from 3.3% in the year to October). The Bank of England left its key interest rate unchanged at 4.75% in December with the majority judging that recent increases in wages and prices had "added to the risk of inflation persistence." Governor Andrew Bailey said: "We think a gradual approach to future interest rate cuts remains right." He added that, with the heightened uncertainty in the economy, "we can't commit to when or by how much we will cut rates in the coming year."

From a political perspective, at least, the UK looks pretty stable compared to European counterparts, in spite of the Labour party's dramatic collapse in popularity since winning one of the largest landslides on record just five months ago. Germany's economy, once the powerhouse of Europe, is now navigating an era of economic stagnation and political turmoil. Chancellor, Olaf Scholz, lost a vote of confidence in the German parliament, paving the way for early elections in February. This came just two months after the collapse of Scholz's three-party coalition government, which had left him leading a minority administration. Meanwhile in France, President Macron's decisions to call a snap-election to try to stabilize the domestic political situation backfired as he ended up with a "hung" National Assembly divided between three roughly equal and politically incompatible factions. The newly-appointed Prime Minister Michel Barnier came and went as he failed to pass an austerity budget to rein in France's growing fiscal deficit while his replacement – France's fourth since the beginning of the year – Francois Bayrou hopes to see off another no-confidence vote from a bitterly divided parliament.

"GOLD, PERHAPS MORE MINDFUL THAN EQUITY MARKETS WERE OF GEOPOLITICAL TENSIONS AND BALLOONING BUDGET DEFICITS, PERFORMED VERY WELL AND HIT NEW ALL-TIME HIGHS IN OCTOBER."

2024 was a year of political upheaval in Japan too. For only the second time this century, the long-standing coalition of the Liberal Democratic Party (LDP) and Komeito lost its majority in the lower house and Prime Minister Shigeru Ishiba now runs a fragile minority government. Nonetheless, the end of deflation, rising wages and the return of some steady growth is powering Japan's economy, and it is an area where we continue to find some good investment opportunities, both direct and via more specialist collective funds, particularly as recent corporate governance reforms have encouraged companies to use excess cash to improve shareholder value.

The Chinese economy continued to face significant growth headwinds in 2024 with several structural factors weighing on inflation, including the multi-year real estate downturn and persistent industrial overcapacity. A series of government stimulus measures announced in September appear to show a strong consensus among policymakers to put a floor under any further downside risks to the economy. However, a sharp fall in Chinese bond yields towards the end of the year does not bode well for the market's expectations of a return to economic growth this year and next. Chinese stocks are trading at cheap valuations, not seen in over a decade, but it is yet to be seen whether government stimulus measures will be enough to kick-start the economy.

In contrast, economic growth continues apace in India. The market's confidence in India's growth picture has driven stock market valuations higher and higher. Indian equities have now more than tripled since their April 2020 pandemic lows. Billions of dollars of inward investment are pouring into local manufacturing as global businesses look to diversify supply chains beyond China and Modi's business-friendly reforms continue to bear fruit. Although the market now looks expensive – especially mid and small-cap stocks – our investment in a specialist Indian trust has been one of our most successful investments in recent years.

Outside equity markets, fixed interest investments did little to help our portfolios' performance last year as, although interest rates fell, they did not fall by as much as expected. However, gold, perhaps more mindful than equity markets were of geopolitical tensions and ballooning budget deficits, performed very well and hit new all-time highs in October. Central banks, particularly in emerging markets, have been big buyers of precious metals as they look to diversify their reserves away from the US dollar at a time of global economic fragmentation. Gold investors also find themselves in a sweet spot between modestly falling but still sticky inflation and gradually easing monetary policy – our position in a physical gold fund benefited accordingly.

2024 SUMMARY

Although the two funds returned a respectable +3.70% and +4.05% over the year, ahead of bonds and the annual rate of inflation, we need to address the poor relative returns when compared to global benchmark indices that were dominated by US equities. We have held for several years three of the "Magnificent Seven" (Microsoft, Alphabet and Amazon) and these have performed well for us; however, despite seeing good returns from these three we are, by any metric, underweight the parts of the market directly exposed to technology and the broader digital economy. We do not have direct holdings in Apple, Tesla, Meta and Nvidia all of which materially outperformed last year and are now very large parts of the benchmark index. Nvidia, alone, accounted for around 22% of the S&P 500's gains last year - almost any active strategy would need to have been meaningfully overweight one or more of these stocks to have outperformed. Other names that now make up large weightings in US indices include Broadcom, Berkshire Hathaway, and JP Morgan and these also contributed strongly to overall benchmark returns but were not held in either of our funds during 2024.

We continue to advocate a more "balanced" approach with exposure to growth stocks sitting alongside more value-orientated investments that do not require excessive growth to justify their stretched valuations. Although performance last year at the index level was dominated by a handful of large companies, we feel that returns in 2025 are unlikely to be concentrated in so few names. Given our underperformance though, which began in earnest over the second half of last year, we felt that it could be useful at this stage to reiterate the investment case for some of the less fashionable investments in our portfolios where we see good long-term value for patient investors:

IBM is an old-world technology company that has made inroads in advanced computer chips, quantum computing, AI, and data infrastructure. IBM booked more than $3b in generative AI-related business last quarter, a gain of more than 50% on the previous quarter. Around three quarters of this comes from its consultancy business and the rest from software sales. Meanwhile, there have been recent redundancies in higher level staff and by controlling its cost base and becoming a more stream-lined company, IBM has improved gross margins. While IBM is not in bargain territory, on 20x forward earnings and a 3% dividend yield, it still looks attractively priced compared to other technology names.

Balfour Beatty

Balfour Beatty is a leader in UK and US infrastructure and construction markets. It has won several large contracts in the power transmission sector that should underpin the order book over the coming years. The UK is set to install five times more power transmission cabling in the next 10 years than was installed in the last thirty. Through a combination of ordinary dividends and a multi-year share buyback programme, Balfour Beatty has returned c.£755m to shareholders over the last three years (about a third of the current market capitalisation), and this is set to continue. The shares trade on 11x forward earnings and a 2.6% dividend yield.

Nike has seen global sales fall following a botched moved towards more direct-to-consumer sales, and unwelcome competition from newcomers such as On and Hoka. The shares have more than halved since their peak in late 2021. But with the return of Elliott Hill as CEO, Nike is starting to clear inventory overhangs and improve gross margins. With new management (getting the old team back together) they will be back to focusing on sport and innovation – the things that made the brand the force it was. The shares now trade on a discount to their historic average and the athleisure giant remains a global brand with significant recovery potential.

Walt Disney is another powerful brand that has underwhelmed in recent years with the shares down from around $200 at their peak in 2021 to around $110 today; but we do not believe that the famous flywheel effect is down and out. The Walt Disney Company is designed so that everything that it owns works together and feeds into each other. The studio creates and acquires worlds and characters for films and shows which is its intellectual property ("IP") to build theme parks off, which in turn entices people to buy merchandise. This builds a deeper connection with the wider brand, which makes consumers want to go and see the next film, the cycle continues, and profitability grows. Yet Disney has not delivered in recent years, blighted by Covid, a series of weak film releases and a bloated cost base. The return of Bob Iger in late 2022, as well as – perhaps – a reaction to an activist campaign led by Nelson Peltz, has seen free cash flow notably strengthening as the company focuses content spend on quality not quantity. Meanwhile, Disney+ has turned to profitability. Moana 2 had the best Thanksgiving opening of any film ever and it could help push Disney's revenues from animated films to above $5b for the year. That, plus some incremental decisions including a $3b share buyback, has put a notch in Iger's belt. It trades on a forward P/E ratio of 20x which looks compelling for what is expected to be double-digit earnings growth for the next few years.

Occidental Petroleum is a US-listed oil & gas explorer and producer with operations in the US, Middle East, North Africa and Latin America. In 2019, Warren Buffett helped finance Occidental's bid for Anadarko, securing the deal against the other bidder, Chevron. Since the deal completed, Occidental has been retiring debt in an effort to reduce its large interest burden and has transitioned to buying back shares, growing its dividend and investing in their sector-leading carbon capture business. While the oil price, and industrial commodities in general, have been weak due to over-supply and weaker demand from China, an allocation to resource companies continues to give portfolios balance and some exposure to a commodity driven price spiral as has been the case at the end of previous inflation cycles. Meanwhile, companies in the sector are generally in good health with sound balance sheets, strong cashflow and low levels of debt. Occidental trades on a forward P/E ratio of 14x and our other large investment in the sector, the UK-listed global major Shell, trades on 8.5x for a 4.5% dividend yield.

Our underperformance became more evident in the second half of the year due to a combination of stock-specific reasons and an extension of US outperformance over other parts of the world. It is always disappointing not to capture some of the outsized gains experienced by certain concentrated areas of the equity markets. Nevertheless, we go into 2025 confident that we have a portfolio balanced across different styles and asset classes well-prepared for, and able to take advantage of, any banana skins that the global growth narrative might slip on - particularly in the parts of the US market where valuations look full. We were intrigued but not surprised to see Warren Buffett aggressively selling down some of his equity positions recently and holding much higher levels of cash going into 2025.

We wish all of our clients and readers a healthy and prosperous 2025

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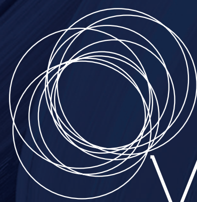

VERMEER
PARTNERS

WILLIAM BUCKHURST
INVESTMENT DIRECTOR

020 7123 5187
william.buckhurst@vermeerllp.com

Vermeer Partners

130 Jermyn Street,
London SW1Y 4UR

020 7123 5200
info@vermeerllp.com
www.vermeerllp.com