QUARTERLY
INVESTMENT REPORT

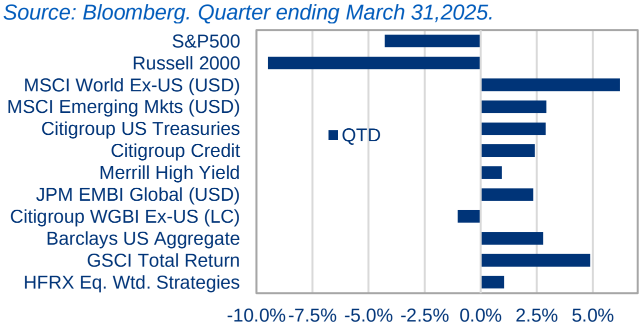
Q1 2025

Strategic Investment Group®

Global Market Review

Policy uncertainty and concern that massive U.S. tariff increases would slow growth and raise prices dominated markets in the first quarter. Business and consumer sentiment soured. Firms deferred hiring and investment. Households feared sharply higher inflation, declining employment opportunities, and deteriorating financial conditions. The economic disruption of policy uncertainty was mirrored in market movements. U.S. equity prices fell sharply. Investment grade and high yield bond prices also declined. Non-U.S. equity markets, especially European and Chinese equities, performed much better than the U.S., despite uncertainty about the impact of increased U.S. tariffs on their exports. The U.S. dollar fell. Gold prices, in contrast, soared. As the quarter closed, markets anxiously awaited more clarity on the level and scope of tariffs. As we now know, such clarity as was provided offered little comfort.

Exhibit 1
Performance of Major Market Indices
Source: Bloomberg. Quarter ending March 31,2025.



U.S. stocks lag other markets in the first quarter.

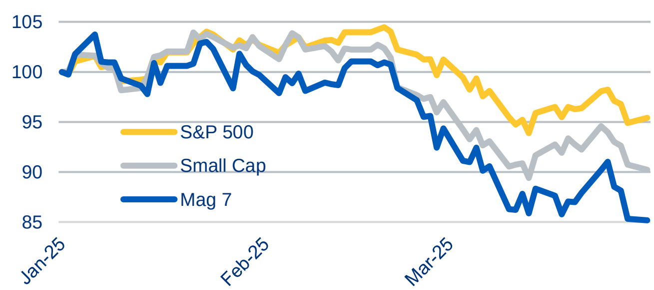
Uncertainty Sends U.S. Equities Lower

The U.S. equity market entered the year buoyed by exuberance but burdened by excess valuation. It ended the quarter shaken by uncertainty.

Despite the first quarter's steep decline, the valuation of the U.S. equity market remains quite high relative to its own history and other markets. Elevated valuations are vulnerable to changing sentiment in the best of times. They are especially at risk when uncertainty is also high.

The abrupt about face in U.S. trade, defense, and foreign policies is undermining the aura of "U.S. exceptionalism" that had buoyed equity valuations. Given the large foreign holdings of U.S. assets – 20% of U.S. equities, 30% of U.S. Treasuries, and 30% of U.S. credit – a loss of confidence in U.S. assets would have far-reaching consequences for asset prices, debt sustainability, and the stability of the global financial system. At the limit, a crisis of confidence could cast doubt on the role of the U.S. dollar as the world's reserve currency.

Exhibit 2
Policy Uncertainty Weighs on U.S. Equity Market
Source: Bloomberg. Index January 1, 2025 = 100.



The S&P 500 index fell 4.3% in the first quarter. Mega-cap tech stocks proxied by the Magnificent 7 led the market lower (Exhibit 2). Tesla, hard hit by investor revulsion, plunged 32% in the first quarter. Small-cap stocks have also underperformed the broader market. Growth stocks lagged value in the first quarter, falling 10% versus value's gain of 1.6%. Across sectors, consumer discretionary (which includes Tesla) and technology were the biggest losers, declining 13.5%, and 12.9%, respectively. Stocks in the energy sector performed best, gaining 9.3%.

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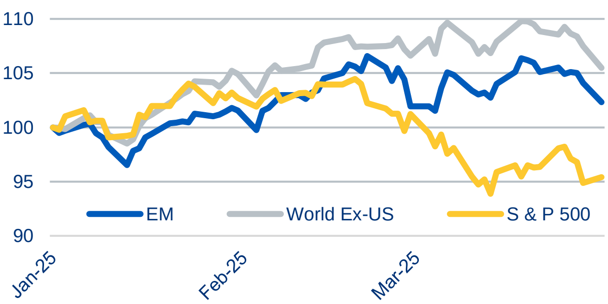
Non-U.S. Equities Led by Europe and China

The MSCI World ex-U.S. index of advanced economy stocks rose 6.2% in the first quarter (Exhibit 3), handily outperforming the U.S. market. European markets performed especially well, despite high energy prices and the threat of tariffs. The main drivers of the European market's gains included signs of resurgent European economic growth, the prospect of a massive German fiscal stimulus and higher defense spending across the continent, expectations for further monetary easing by the ECB, greater political stability following the recent election cycle, and a potential reduction in regional conflicts.

Exhibit 3
U.S. Lags Advanced and Emerging Market Equities
Source: Bloomberg. Index. January 1, 2025 = 100.

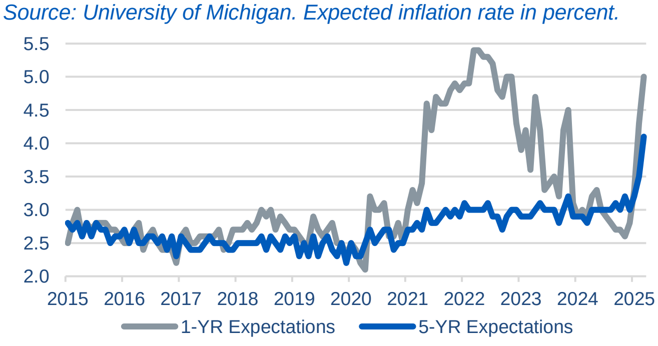


Emerging equities were up 2.9% in the first quarter of the year. Chinese equities jumped 15%. This performance was underpinned by strong gains in the tech sector following a breakthrough in AI by DeepSeek's LLM and fiscal and monetary stimulus aimed at boosting the broader economy and the stock market.

Inflation Expectations Jump

There are worrisome signs that household inflation expectations may be becoming unanchored (Exhibit 4). An instability in long-term inflation expectations is especially risky in the current environment. Expectations will determine whether the impending tariff-induced increase in the price level is a one-off event or the trigger of an inflationary spiral.

Exhibit 4
Inflation Expectations Spike
Source: University of Michigan. Expected inflation rate in percent.



So far, the inflation concerns of households have not been matched by market-based measures of long-term inflation expectations. The decline in 10-year Treasury yields in the first quarter has been dominated by a decline in real yields, with 10-year average inflation expectations remaining little changed. However, the market's short-term expectations for inflation, like those of households, have spiked.

Hedge Funds Generate Modest Gains

The HFRX equal-weighted hedge fund index rose 1.0% in the first quarter. Equity market neutral and merger arbitrage strategies led all others, gaining 2.1% and 2.0%, respectively. Global macro strategies lagged, losing 0.8%. Alpha opportunities for skilled hedge fund managers to exploit remain abundant, while the high level of market volatility makes low beta strategies especially valuable as a source of portfolio resilience and diversification.

Real Estate Repricing Continues

Real estate, as measured by the NCREIF Open-End Funds Core Index (reported with a delay), lost 2.3% in the 12 months through December 2024. Retail, industrial, and multifamily property valuations stabilized as net operating income grew. Office valuations continued to decline.

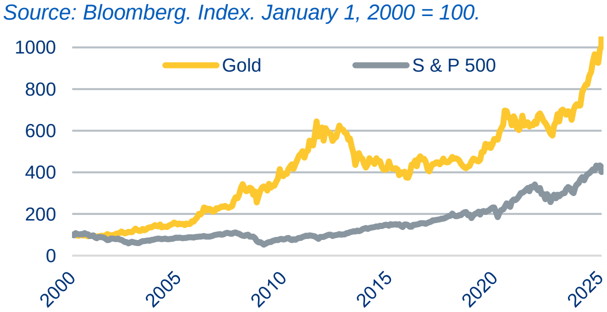
Venture Headwinds Ease

Based on preliminary estimates, the Thomson Reuters/Cambridge Index was up 7.8% for the year ending December 2024, extending its period of modest performance in a low transaction environment. Buyout and growth equity strategies gained 8.8% and 8.9%, respectively. Buoyed by the frenzy over AI, venture valuations rose during the year, and the venture capital portion of the index gained 6.8%.

Golden Twenty-First Century

President Nixon suspended the dollar's fixed peg to gold at $35 per ounce in 1971, thus ending the Bretton Woods system governing international trade and payments. Since then, the value of the dollar has fallen from 1/35th of an ounce of gold to 1/3,000th of an ounce. The price of gold has risen especially fast since the Great Financial Crisis, reaching $1,000 for the first time in 2008, $2,000 in 2020, and $3,000 in March. Gold has handily outperformed U.S. equities and other assets in the 21st century, reflecting concerns, at various times, over financial stability, price stability, and geopolitical stability (Exhibit 5). It was up 18% in the first quarter, outperforming all other assets.

Exhibit 5
Gold Outshines Equities and Other Assets
Source: Bloomberg. Index. January 1, 2000 = 100.



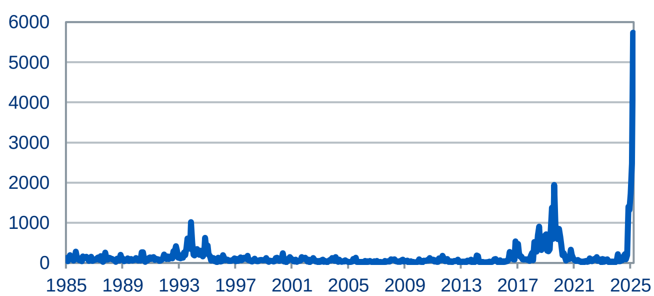
Outlook & Strategy

Erratic Policies Volatile Markets

Markets work best when underlying conditions change gradually. When there are massive and sudden swings in underlying conditions as a result of abrupt policy reversals, the ability of markets to provide reliable price signals and allocate resources efficiently breaks down. More insidiously, confidence in the market and in the framework governing its operation also erodes leading to paralysis, and in the worst case, panic.

The hallmark of optimal policy setting is unobtrusiveness. Economic policy makers are acutely aware that policy change invariably entails unintended consequences. They therefore typically follow a consultative, incremental, and predictable approach to policy change.

Exhibit 1
Trade Policy Uncertainty Spikes to Record Levels
Source: Economicpolicyuncertainty.com. Index 1985-2009 = 100.

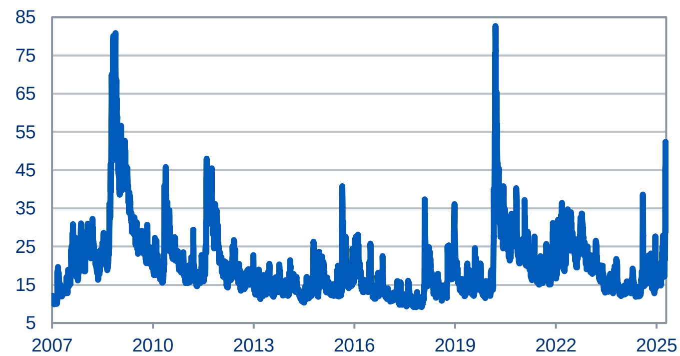


Policy setting in the first quarter has been anything but unobtrusive. Economic policy uncertainty is near record levels and trade policy uncertainty is off the charts (Exhibit 1). Policy uncertainty has shaken consumer and business confidence and pushed inflation expectations to four-decade highs. Policy uncertainty has also triggered elevated market volatility. Market measures of expected volatility in the U.S. equity market recently touched levels only exceeded at earlier crisis peaks (Exhibit 2). Bond and currency market volatility is also high.

There are worrisome signs of a shift out of U.S. dollar assets by foreign investors who hold in aggregate about 20% of U.S. equities, 30% of U.S. Treasuries, and 30% of U.S. credit. The dollar has fallen sharply against major currencies and U.S. Treasury yields are up. Gold prices are soaring.

The ultimate risk scenario would be a loss of confidence in the U.S. dollar's traditional role as the world's preeminent reserve currency and the U.S. Treasury market's role as the ultimate safe haven. While still a remote possibility, a loss of confidence in the U.S. dollar would have far-reaching consequences given the centrality of the dollar in central bank foreign exchange reserves (57%), international trade invoicing (54%), global derivatives trading (88%), and currency trading (88%).

Exhibit 2
Policy Uncertainty Sows Market Volatility
Source: Bloomberg. The VIX is an option-based measure of short-term volatility of the S&P500.



Double Down on Bottom Up

When and where the ongoing policy swings ultimately settle will have a major impact on economic growth, inflation, profit margins, and asset risk premiums. In this volatile and highly uncertain environment, we have redoubled our focus on exploiting valuation anomalies across individual securities, while keeping a broadly neutral stance across public equities and credit. The risk of being whipsawed by abrupt shifts in economic policy makes any attempt to add value through top-down active management especially fraught.

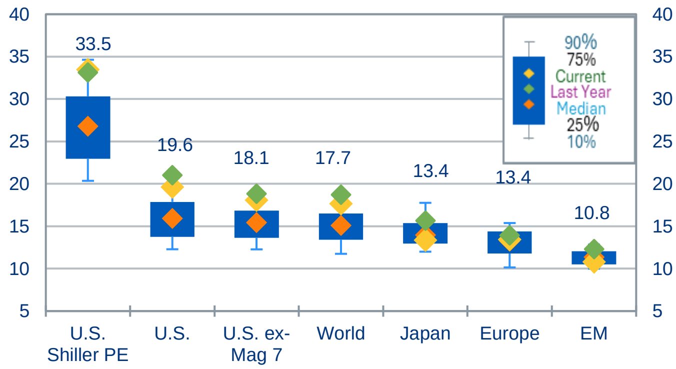
Our focus on bottom-up security selection rather than top-down asset allocation helps to avoid the risk of being blindsided by changing policies, contributes to portfolio resiliency, and offers significant opportunities for adding value. Strategies that focus on exploiting anomalies in the pricing of individual securities are typically the most rewarding, most persistent, and most reliable source of alpha. Moreover, portfolios encompassing many uncorrelated sources of value added are inherently more resilient, a critical feature in the current volatile environment. Persistently wide valuation dispersion within markets continues to provide a favorable environment for strategies focusing on active security selection.

Behind the scenes, we are enhancing the quantitative analytical capabilities that guide how we evaluate managers and construct portfolios to add value for our clients. These include enhancements to our private markets, fixed income, and performance attribution analytics. We are also upgrading the systems we use for database management and the design of internal client portfolio and market data dashboards.

U.S. Equity Valuations Remain High

Despite recent declines, U.S. equity valuations remain high compared to history as well as the valuations of other equity markets (Exhibit 3). We are maintaining a neutral allocation to public equity overall, while remaining underweight to the overvalued U.S. market. Within the U.S. market, we continue to favor managers whose strategies gravitate toward value stocks – firms with solid balance sheets and strong earnings.

Exhibit 3
U.S. Equity Valuations Remain High Despite Declines
Sources: Shiller Data, FactSet, and Strategic calculations. Shiller Cyclically Adjusted Price Earnings Ratio (CAPE) calculated using 10-year smoothed real earnings per share. Other data are 12-month forward P/E ratios. Data as of April 11, 2025.



We have structured the U.S. equity portfolio to include active long-only managers using a combination of quantitative and fundamental techniques, risk-controlled extension and portable alpha strategies, and industry-focused specialty managers in the biotech sector. Through this structure, we aim to increase the scope for value added through security selection, diversify the sources of portfolio return, and enhance the resilience of the portfolio.

Outside of the U.S., we continue to target a modest overweight to advanced and emerging equity markets reflecting their more attractive valuations. We are pursuing four major initiatives to boost the value-added potential of the non-U.S. equity portfolio. First, we are expanding our roster of country specialist managers to be better positioned to exploit pricing anomalies within individual markets. Second, we are exploring the global equity manager landscape to find promising candidates to complement our current roster of global managers. Third, we are considering ways to restructure our emerging market portfolio with a special focus on East Asian markets. Finally, we are reevaluating our current non-core emerging market manager line-up.

Tariffs Spark Stagflation Fears

U.S. bond market volatility has been high. At the short end of the yield curve, real yields have fallen while break-even inflation expectations have shot up and the yield curve between 3-month and 2-year maturities is inverted. This constellation suggests concern over the increased risk of stagflation. Yields at the long end of the curve have risen sharply. Uncertainty has sent long-term term premiums higher while market volatility has led to the abrupt unwinding of highly levered basis trades by hedge funds. Looming ominously over the market is the tail risk of declining trust in the dollar and the Treasury market's value as a safe haven.

We continue to target a neutral stance to duration and credit exposure in the fixed income portfolio. Our barbell approach to portfolio construction using U.S. Treasury securities to balance exposures to higher yielding credit products provides us flexibility to exploit anomalies in the pricing of credit securities and adapt bond portfolios to changing circumstances. The heterogeneous and segmented credit markets continue to offer attractive opportunities to specialist managers with the requisite experience to discriminate among issuers in niche segments of the market.

As part of our ongoing efforts to boost the value-added potential of the fixed income portfolio, we have started a search for long-credit managers as well as managers focusing on emerging debt markets. We are also complementing our fixed income portfolio with opportunistic investments in less liquid credit strategies, and by expanding our positions in the direct lending market.

High Alpha, Low Beta – Hedge Fund Ideal

We believe that hedge fund portfolios are the ideal portfolio diversifier and source of value added. These characteristics are especially important in the current environment of uncertainty and volatility. Our focus on constructing low-beta hedge fund portfolios comprising highly diversified streams of alpha approaches an optimal tradeoff between risk and return. We continue to target a neutral allocation to hedge funds. This positioning balances the benefits of hedge funds against the desirability of maintaining sufficient liquidity to rebalance client portfolios in case of asset market swings.

Selective Opportunities in Real Estate

The real estate market remains under pressure, although a few sectors offer attractive opportunities. We continue to delay new commitments to open-end funds and are avoiding new investments in the office sector. We are, however, making new commitments in the industrial and housing sectors of the market where valuations are favorable. We are retaining a neutral allocation to TIPS as another source of real yield and a further inflation hedge.

Private Equity Market Opportunities

Private firms represent a large, growing, and dynamic segment of the U.S. economy that offers attractive opportunities for strong returns and added value. We continue to exploit these opportunities focusing on middle market firms with solid earnings growth in the industrial, technology, and consumer sectors. Our portfolios include a combination of buyout and growth equity funds at their core combined with smaller positions in venture capital investments. We believe that our prudently constructed portfolio will continue to prosper. We are considering complementing this portfolio with purchases in the growing secondary market for venture capital investments.

Special Topic

Costs of Radical Uncertainty

Markets take risk in stride. They are after all continuously discounting changing circumstances and attaching probabilities to unknown future outcomes. Markets are less adept, however, at coping with radical uncertainty, unknowns which cannot be characterized probabilistically.

Markets are attempting to cope with unprecedented levels of radical uncertainty concerning the scope, magnitude, timing, and persistence of tariffs. The magnitude of the proposed tariff changes, the suddenness of their implementation, and the repeated abrupt reversal of policy are compounding the difficulties markets face. The daily vacillation of U.S. tariff policy is not the only factor fueling uncertainty. The extent of retaliation by other countries is also unknown.

Nor is uncertainty limited to trade policy. The continued independence of the Fed is also in doubt, undermining confidence in the dollar as the preeminent global reserve currency and U.S. Treasuries as the ultimate safe haven. Uncertainty is further heightened by suggestions by the Chair of the Council of Economic Advisors that it might be advantageous to convert all or part of the existing stock of outstanding U.S. Treasury securities into zero coupon century bonds. Escalating uncertainty on multiple fronts is likely to have a profound impact on economic activity and increase financial fragility.

Tariffs Pose a Massive Supply Shock

The level of tariffs being imposed, if they persist, would represent a supply shock that would push inflation higher while slowing growth. Tariffs of the magnitude envisaged would disrupt existing supply chains and longstanding patterns of consumption and production, raise input costs to firms and the prices paid by consumers, and reduce the markets open to firms and the products available to consumers.

According to estimates by the Yale Budget Lab, the U.S. tariffs and foreign retaliation as of April 15 would cut the disposable income of the average U.S. households by $4,900, a supply shock equivalent to doubling the price of gas. Once households adjust their consumption patterns, the long-term annual decline in disposable income is estimated at $2,600 in 2024 dollars.

Faced with the possibility of a massive supply shock, consumer and business sentiment has plunged. Households expect their employment and financial prospects to fall as the prices they pay for necessities soar.

The prospect of wild swings in input costs and declining demand for their products has led firms to put new hires and capital expenditure on hold, and to raise their sales prices. Others, faced with a sudden increase in input costs, are renegotiating existing contracts. Many small businesses face the prospect of going out of business.

Firms and consumers are front-loading purchases of goods likely to be subject to tariffs, distorting economic signals. The inventories being built to avoid tariffs will pose a drag on growth as they are drawn down. This inventory drag will compound the eventual tariff-induced hit to growth caused by higher prices and reduced supply.

A supply shock of this magnitude would pose a dilemma for the Fed in fulfilling its dual mandate. The Fed would have to choose between preserving price stability and countenancing economic contraction or prioritizing growth and allowing inflation to become entrenched.

Survey data from the University of Michigan point to a sharp rise in household long-term inflation expectations. Once entrenched, expectations for price increases are projected forward in contracts, creating a self-fulfilling cycle. Breaking this cycle typically requires shock therapy to reset expectations. The Volker shock of the 1980s, which sent 3-month T-bill rates to over 15% and resulted in a prolonged economic contraction, is a case in point.

An erosion of Fed independence would undermine confidence in its ability to restore price stability. This in turn would allow inflation expectations to become deeply entrenched, thus raising the ultimate cost of restoring price stability.

Uncertainty Increases Financial Fragility

In normal times, markets can adjust to changing perceptions of risk in an orderly fashion. Faced with radical uncertainty, however, there is no reliable probability distribution of future outcomes. Risk becomes more difficult to measure and risk premiums can be highly volatile, undermining the orderly functioning of markets and increasing financial fragility.

So far, markets have remained orderly. Although most U.S. asset prices have declined and equity, bond, and currency volatility has spiked, these moves have not risen to crisis extremes. While rising long-term bond yields, a depreciating dollar, and soaring gold prices suggest some movement out of the dollar, there does not yet appear to be a concerted restructuring of foreign holdings out of dollar assets.

Part of this orderly market response reflects the possibility that tariffs of the magnitude now being imposed will prove short-lived as negotiations with trading partners bear fruit. While a hopeful prospect, the result of ongoing negotiations is itself unknowable, adding a further element of radical uncertainty.

In this environment, the best portfolio strategy is a focus on bottom-up strategies aimed at strengthening portfolio resilience and exploiting pricing anomalies across individual securities. Heroic top-down positions have no place in the face of radical uncertainty.