January 2025

From this weekend's WSJ:

Indexes Notch January Gains Despite Bumps

Stocks rose even as fears over tariffs, rates and China's AI win rattled investors

BY RYAN DEZEMBER

Financial markets finished a bumpy month broadly higher, with everything from gold and government bonds to stocks at home and abroad notching gains despite escalating trade disputes, an uncertain path for interest rates and the DeepSeek AI shock (see The AI Meltdown below).

Investors were rattled in the final hours of January trading when the White House said Friday afternoon that it would place tariffs starting Saturday on major trade partners Canada, Mexico and China.

Major U.S. stock indexes had been trading higher Friday morning after another solid batch of corporate earnings reports and economic data on personal spending met expectations. But they reversed course following the tariffs announcement.

The technology-heavy Nasdaq Composite, which had been up nearly 1.5%, ended 0.3% lower. The S&P 500 shed 0.5%. The Dow Jones Industrials dropped 0.8%, or 337 points, on the day, dragged down by a 4.6% decline in shares of oil major **Chevron.**

Major indexes still ended the month higher. The bluechip Dow gained 4.7%, the S&P 500 added 2.7% and the Nasdaq rose 1.6%.

European stocks had an even better January. The Stoxx Europe 600 Index rose more in January than it did during all of 2024, climbing 6.3% to end at a record high. London's FTSE 100 and Germany's DAX also closed at records, notching January gains of 6.1% and 9.2%, respectively.

Gold futures notched a record on Thursday, rebounding from a postelection swoon. Though front-month gold futures ended Friday down a bit at $2812.50 a troy ounce, the precious metal rose 7% in January and had their biggest monthly gain in dollar terms since August 2011. Bond funds and bitcoin were January winners as well.

Bond yields rose Friday after White House press secretary Karoline Leavitt said tariffs of 25% would be imposed on Canada and Mexico and 10% on China. The yield on benchmark 10-year Treasury notes had been trending lower since mid-January, and ended the month down slightly at 4.566%.

Looming tariffs under the Trump administration reignited concerns that inflation may tick higher, derailing the possibility of further interest-rate cuts. Earlier in the week, the Federal Reserve held steady on the benchmark federal-funds rate, opting to wait and see how the economy performs before cutting again. ...

There were few losing stock markets. Japan's Nikkei 225 ended the month 0.8% lower.

Chip maker **Nvidia,** the must-have stock of the artificial-intelligence frenzy, took a big hit after China upstart DeepSeek said in January that it had trained a sophisticated AI model far more efficiently than rivals. Nvidia shares lost 11% in January, or $348.2 billion in market valuation.

The decline of one of the market's largest stocks dragged the S&P 500's information-technology segment to a monthly loss, the only industry group to end lower. It wasn't all bad, even for tech stocks. **Meta Platforms,** another AI player, gained 18% during the month, adding $268.3 billion of market value. ...

From Global Investment Strategy on January 27th:

Peter Berezin's Thought Of The Day: The AI Meltdown - Two Economic Terms To Remember

Just because a new technology lifts productivity does not mean it will lift profits. The internet is a classic example. The rollout of the internet helped boost US productivity growth by about one percentage point between the mid-1990s and the mid-2000s (**Chart 1**). However, it was only around the mid-2000s that companies started making serious money from the internet, by which point the dotcom bubble had already burst and productivity growth had started to go back down.

In other words, the productivity preceded the profits by 10 years!

When tech companies finally did figure out how to monetize the internet, they did so by harnessing two economic forces that allowed them to create natural monopolies for their businesses: 1) network effects; and 2) economies of scale.

Network effects stem from the fact that certain technologies become increasingly attractive when more people use them. Social media platforms are a classic example: Lots of people use Facebook and Instagram because many other people use them.

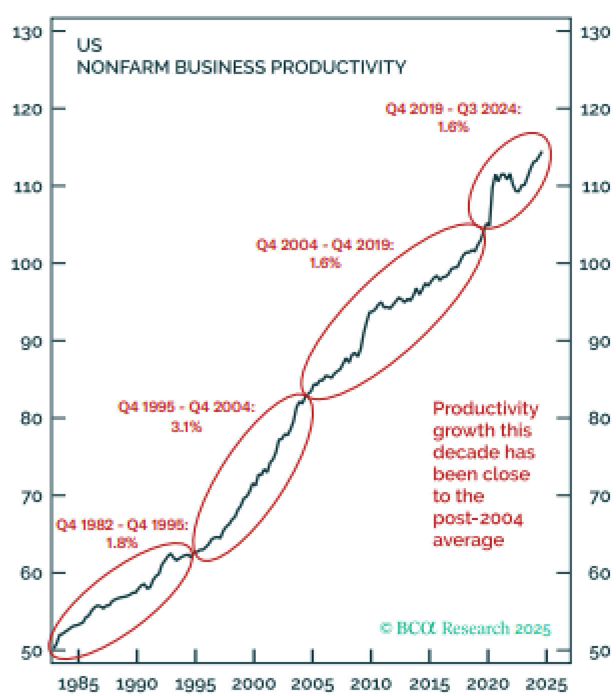
Bitcoin is another example. People value Bitcoin simply because other people value Bitcoin. There is nothing special about Bitcoin's algorithm other than it was the first to come on the scene.

Network effects tend to apply to software in general. I am currently typing this note on a Windows PC - not because I like Windows but because that is what most of my colleagues use.

The problem for large language models is that they do not benefit from network effects to any great degree. If I use ChatGPT, it does not really matter to me if others use it too.

This brings me to the second force that sustains tech profits: economies of scale. Economies of scale occur in cases where there are high fixed costs and low marginal costs. Again, software is a good example: It takes a lot of money to produce a good piece of software but once the code is written, creating additional copies is almost costless.

CHART 1
The Rollout Of The Internet Helped Boost US Productivity Growth



SOURCE: BUREAU OF LABOR STATISTICS (BLS).
NOTE: VALUES IN RED DENOTE ANNUALIZED GROWTH.

Large language models do not fit neatly into this fold. As it turns out, creating large language models may not be that expensive (especially if they are based on open source technologies). In contrast, using them on an ongoing basis is expensive, not just because of the pricey chips required for inference, but also because of the energy costs needed to run all those data centers where those chips are housed.

In that respect, large language models are a lot like airlines. Airlines are indispensable for global commerce but never seem to make much money because of their high operating costs and the fact that they are largely indistinguishable from one another.

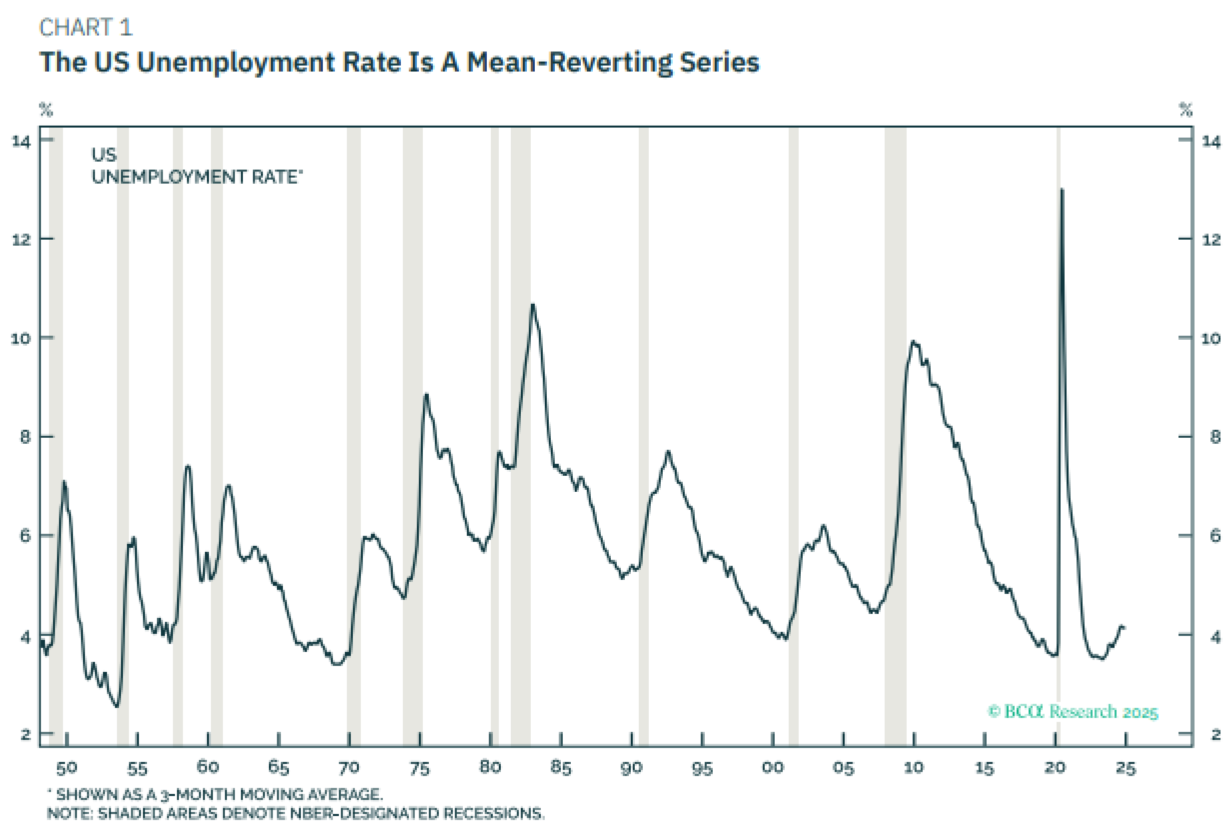
A few weeks ago, Sam Altman admitted that OpenAI is losing money on its $200 per month ChatGPT Pro plan. However, he spun this news in a positive light, emphasizing that OpenAI was losing money on the service only because people were using it so much. This raises the question: When will OpenAI be able to eventually raise prices to cover its costs? As the fracas over DeepSeek reveals, the answer may be “not anytime soon.”

From Global Investment Strategy's January 23rd Report:

Still On The Tightrope

The Curse of Full Employment

The unemployment rate in the US is a mean-reverting series. In the past, whenever it has fallen to levels consistent with full employment, it has usually started rising again (**Chart 1**).



Why can’t the unemployment rate go down and stay down?

CHART 5A

US Growth: Some Constructive Signs (I)

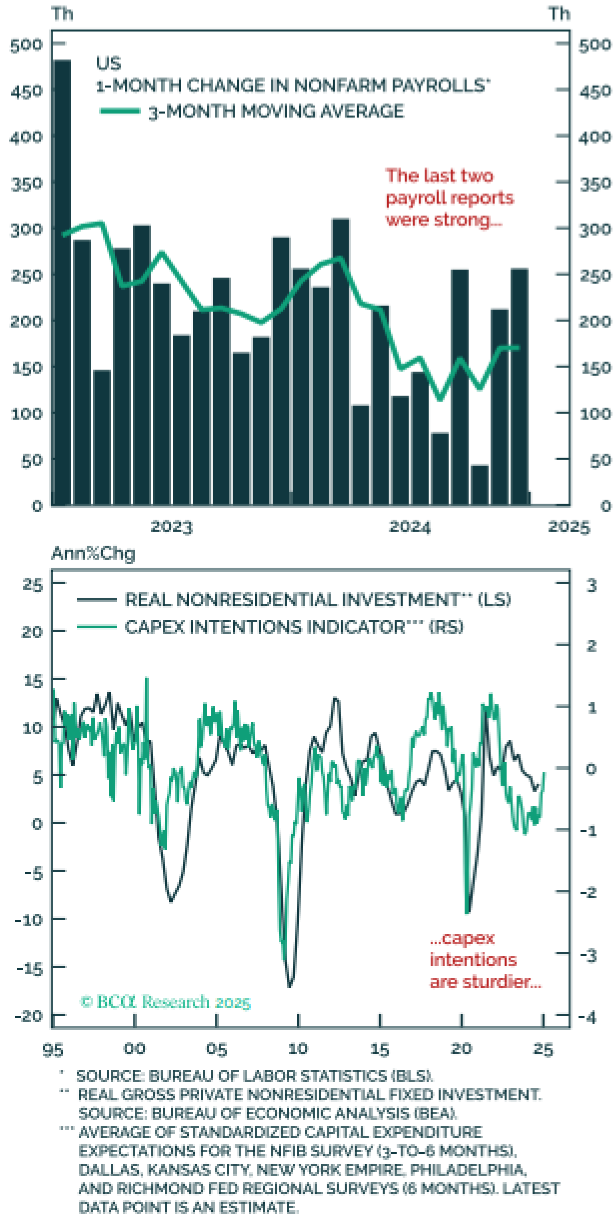
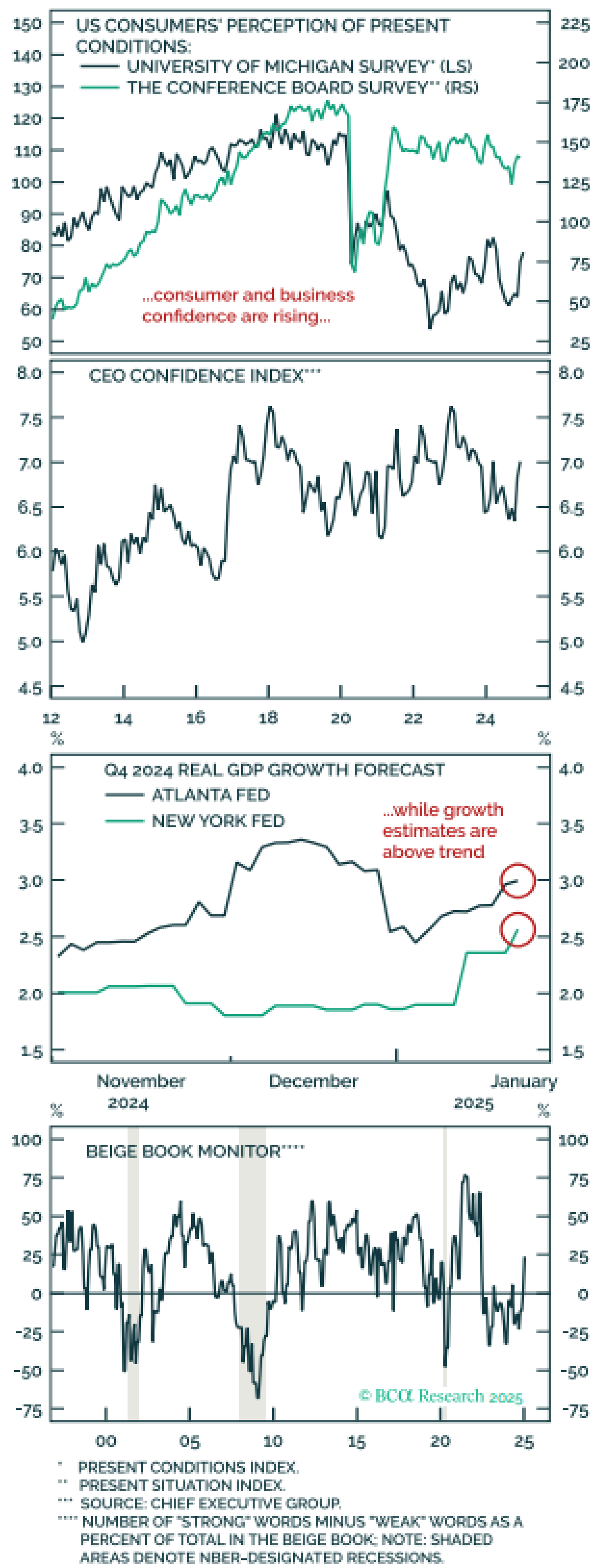


CHART 5B

US Growth: Some Constructive Signs (II)



The answer is that it is very difficult to keep an economy at full employment. At full employment, if growth rises above trend, inflation will accelerate, forcing central banks to hike rates. On the flipside, if growth falls below trend, unemployment will start to increase. Rising unemployment can engender a feedback loop where falling income leads to less spending, leading to even less hiring.

Notice that this is only a problem when an economy is operating at less than full employment. When there is plenty of slack, central banks can keep interest rates below neutral. Yes, the economy will grow at an above-trend pace, but with plenty of spare capacity, inflation is unlikely to rise very much. ...

Nevertheless, one should not dismiss the past two strong payroll reports, sturdier capex intentions, rising consumer and business confidence, above-trend GDP growth tracking estimates, and the improvement in tone from the latest Fed Beige Book (**Chart 5**).

Three forces contributed to the acceleration in US growth:

- The lagged effects from the prior easing in financial conditions. The 10-year US Treasury yield fell a full percentage point between end-April and mid-September 2024, with mortgage rates dropping by even more than that. This decline in yields was accompanied by a weakening dollar, lower oil prices, and a rising stock market (**Chart 6**).
- The front-running of import purchases ahead of possible tariffs. Although imports do not directly raise GDP, a lot of domestic value added is still generated in the process of transporting, storing, and selling foreign goods. According to the December S&P Global US PMI, one quarter of surveyed companies reporting increased input purchases attributed their buying decision to tariff risks. Relatedly, vehicle sales jumped in the fourth quarter, which was probably also partly due to the threat of tariffs.
- Rising tech-related capital spending. Tech-related manufacturing construction has soared over the past three years. This spending boom was driven partly by AI euphoria, facilitated by generous government subsidies under the CHIPS Act.

CHART 6
Lagged Effects From Prior Easing In Financial Conditions Have Been A Boon For Growth

* SOURCE: GOLDMAN SACHS VIA BLOOMBERG FINANCE L.P.
** SOURCE: FREDDIE MAC.

Unfortunately, all three tailwinds are likely to subside or reverse over the remainder of the year. We estimate that easing financial conditions boosted growth by 0.5 percentage points in the second half of 2024. However, financial conditions then tightened from mid-September to earlier this month as yields rose and the dollar strengthened. Although conditions have eased again over the past few weeks, we still estimate that the net effect will be to shave around 0.2 points from growth in the first half of 2025.

The front-running of orders will also reverse. In general, trade uncertainty remains highly elevated, which is historically negative for growth. According to news reports, Trump is hoping to generate as much as $1 trillion in tariff revenue. For context, the US imported $4 trillion of goods and services in 2024. ...

Growth Headwinds, Both in the US and Abroad

In addition to the factors discussed above, a number of other domestic headwinds will likely cause US growth to soften. These include the depletion of pandemic savings, rising consumer delinquencies, the resumption of student loan payments, declining residential construction, and increasing stress in commercial real estate (**Chart 10** and **Table 1**).

Slower growth abroad will also exert a drag on the US economy, partly by keeping the US dollar well bid. The German economy shrank for the second consecutive year in 2024. The French economy is near stall speed, with growth estimated to have been close to zero in the fourth quarter. Expectations of rising unemployment have surged in recent months, which is likely to lead to more precautionary savings.

The UK economy appears to have not grown at all in the second half of 2024. The unemployment rate rose by 0.4 percentage points in the three months to November. Early estimates suggest that payrolls dropped by 47,000 in December and by 8,000 over the previous 12 months. Job vacancies have declined for 30 straight months ....

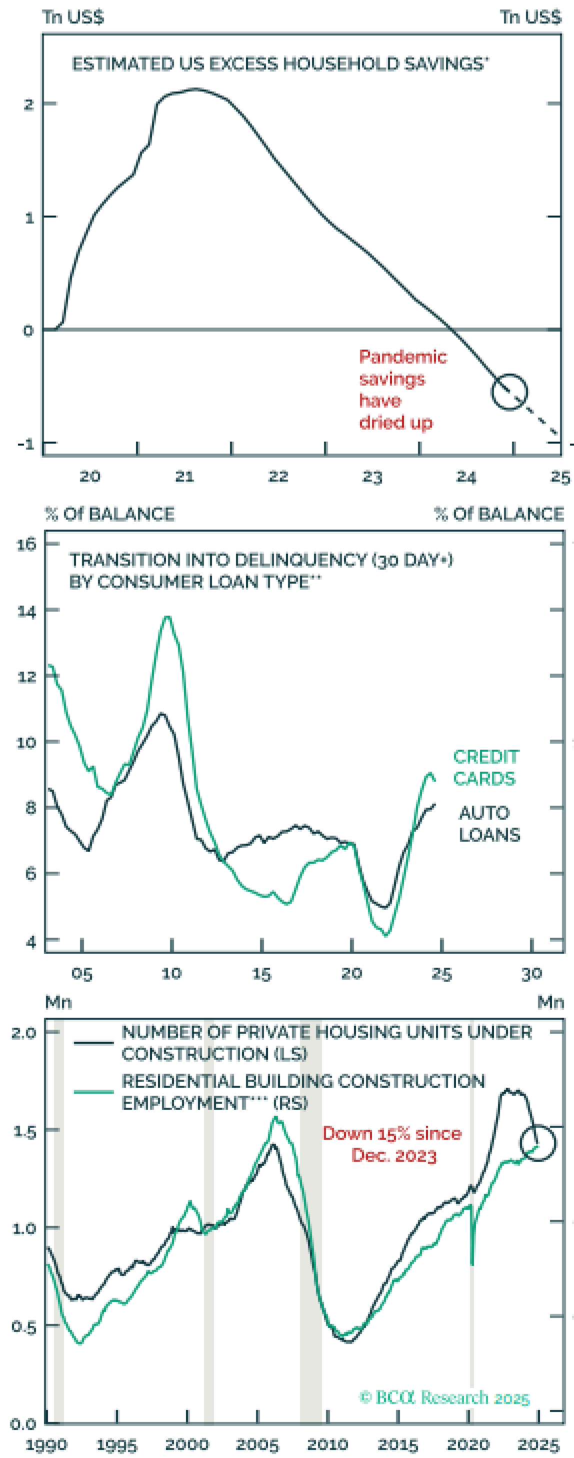
China's economy displayed some renewed vigor towards the end of 2024. However, this likely reflected the front-loading of exports mentioned above, as well as various cash for clunkers schemes which brought forward purchases of autos and appliances at the expense of future demand. Despite some easing in recent weeks, financial conditions remain tight in China. Home construction is weakening, and the decline in floor space started suggests that this trend will continue.

Investment Implications

Whereas growth risks remain top of mind abroad, in the US, worries about renewed overheating have moved back into the spotlight. ...

This reinforces the point we made earlier, which is that the US economy is on a tightrope, destined to oscillate from fears of too little growth to fears of too much growth.

CHART 10
The US Consumer And Housing Sector Are Showing Some Signs Of Vulnerability



* SOURCE: "DATA REVISIONS AND PANDEMIC-ERA EXCESS SAVINGS", H. ABDELRAHMAN AND L. OLIVEIRA, FEDERAL RESERVE BANK OF SAN FRANCISCO, NOVEMBER 8, 2023.
** SHOWN AS A 4-QUARTER MOVING TOTAL. SOURCE: FEDERAL RESERVE BANK OF NEW YORK.
*** SOURCE: BUREAU OF LABOR STATISTICS (BLS).
NOTE: SHADED AREAS DENOTE NBER-DESIGNATED RECESSIONS.

Right now, the economy seems to be shifting back from worries about excessively strong growth. A slowdown in growth from an above-trend to below-trend pace could entail an intermediate phase where growth is near trend and Goldilocks looks even more likely. At least in the short term, that would be bullish for stocks.

Unfortunately, at some point, the economy will fall off the tightrope, leading to a major bear market in stocks.

TABLE 1

Delinquency Rates In The Commercial Real Estate Sector Are On The Rise

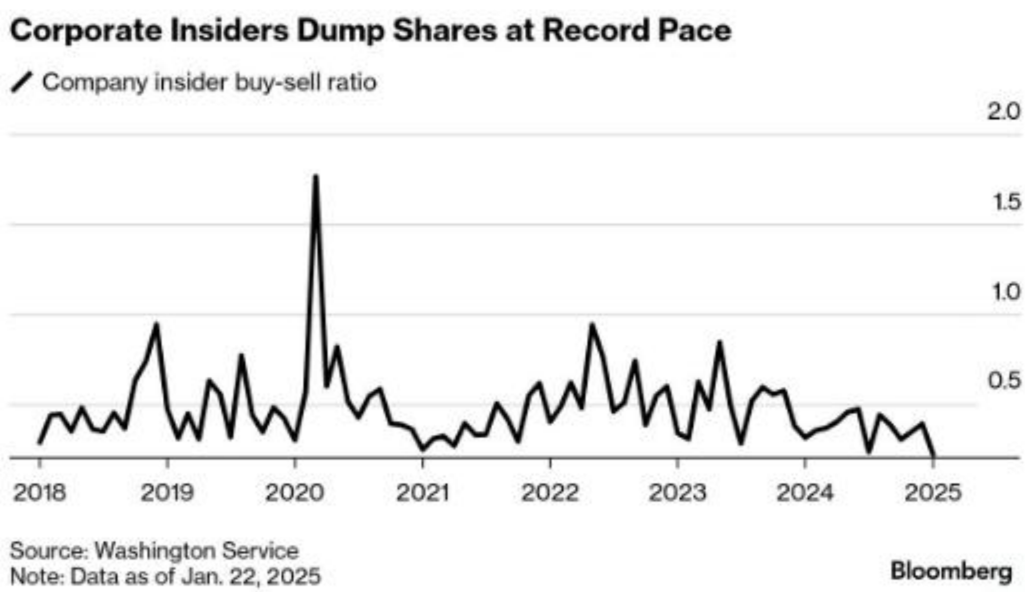
CRED iQ OVERALL DISTRESSED RATES BY PROPERTY TYPE*
DELINQUENT AND / OR SPECIALLY SERVICED LOANS

MONTH	OFFICE	MULTIFAMILY	RETAIL	HOTEL	INDUSTRIAL	SELF STORAGE
Nov-23	6.8%	2.9%	6.6%	6.4%	4.4%	1.3%
Dec-23	9.9%	4.0%	8.4%	8.0%	0.6%	1.1%
Jan-24	10.5%	2.6%	8.0%	6.7%	0.3%	14.4%
Feb-24	11.0%	3.4%	8.4%	6.9%	1.3%	0.1%
Mar-24	11.4%	3.7%	9.5%	7.7%	0.6%	0.1%
Apr-24	11.7%	7.2%	11.9%	8.7%	0.4%	0.1%
May-24	11.1%	7.1%	11.3%	9.4%	0.5%	0.1%
Jun-24	11.5%	7.4%	11.7%	8.1%	1.0%	0.1%
Jul-24	12.2%	8.4%	11.8%	7.8%	0.8%	0.2%
Aug-24	13.0%	11.0%	10.6%	8.4%	4.6%	0.1%
Sep-24	14.8%	11.2%	11.4%	8.6%	0.6%	2.4%
Oct-24	14.8%	11.0%	11.7%	9.0%	1.2%	3.6%
Nov-24	15.5%	11.2%	11.5%	8.6%	0.6%	1.7%
Dec-24	17.2%	12.5%	10.9%	9.9%	0.8%	1.6%

* AS OF DECEMBER 31, 2024.
SOURCE: CRED iQ.

For those clients for whom we invest in individual stocks, our IVE Stock Selection System's first requirement is Insider Buying. From Bloomberg on Jan. 26th:

Shares of US companies roared to a record this week, seemingly shrugging off worries about tariffs, immigration and inflation. Yet, company executives are doing something decidedly less bullish: selling their stocks at a rapid pace.



A gauge of insider sentiment that tallies the number of buyers versus sellers shows there were just 98 companies where at least one insider purchased the company's shares this month through Jan. 22, compared with 447 at which at least one insider sold, according to data compiled by the Washington Service. With a little over a week of trading left in January, that buy-sell ratio, at 0.22, is currently on track to be the lowest in data going back to 1988.

From Ian Bremmer, whom we consider to be the best Geopolitical Strategist available, on Jan. 22nd:

The impact of Trump 2.0 on the American economy

If you listen to Wall Street and corporate America, Donald Trump's second term will usher in a new golden age for the US economy. After all, what's not to love about the return of a business-friendly president advised by a cabinet of self-made billionaires all promising deregulation and tax cuts?

Markets and CEOs have reasons to cheer. Trump inherits a strong US economy from former President Joe Biden. Output is running above pre-pandemic trends, far outperforming other major economies. Unemployment is hovering around 4%, inflation is slowly heading back to the Fed's 2% target, and interest rates are coming down from their peak. It's no wonder stocks are partying like it's 1995. But two of Trump's core campaign promises are set to spoil the party.

First, there's his plan to jack up tariffs (aka "the greatest thing ever invented") to correct "unfair practices," reduce America's trade deficit, and extract concessions from other countries. While the president didn't slap any new tariffs on "day one," as some feared, he did launch investigations that will provide legal cover for significant tariff hikes sooner rather than later.

China will be the primary target as Trump imposes 50-60% levies on some goods and roughly doubles the average tariff rate on all Chinese imports by year's end, aiming to force a deal from Beijing. But though China's economy is in shambles and President Xi Jinping would much prefer to avoid a trade war with the US, he's unlikely to offer concessions generous enough to satisfy Trump and the hawks in his cabinet. Combined with other US moves the Chinese will see as hostile, tariffs will cause Beijing to retaliate and the US-China relationship to break down, hurting American consumers and businesses through higher prices for imported goods and inputs.

Of course, China's not the only trading partner in "tariff man's" crosshairs. Trump's offhand threats on Monday to impose 25% tariffs on Mexico and Canada by Feb. 1 may be bluster, but they confirm his determination to target any country he believes is taking America for a ride. That could include having a large bilateral trade surplus with the US, enabling Chinese circumvention of US tariffs, "free riding" off US protection, "over-taxing" US companies, and anything else Trump sees as adversarial to US interests.

Some countries will cave to Trump's demands. Mexican President Claudia Sheinbaum, for instance, will likely offer up enough concessions to avoid 25% tariffs. But others will lack the policy and political space to placate Trump. Some, like Canada, will feel compelled to hit back with their own measures, raising the risk of an escalatory cycle and a broader trade war that could tip the US – and the world – into recession.

Even if we avoid that worst-case scenario (as is likely), Trump's initial tariffs will still disrupt supply chains, distort trade flows, and raise costs for US businesses and consumers – with lower-income Americans taking the biggest hit. And here's the kicker: Not only will tariffs fail to "enrich our citizens" – Trump's purported goal – they also won't meaningfully reduce America's overall trade deficit or bring back manufacturing jobs.

Then there's immigration, the second key plank of the president's agenda. Trump wasted no time showing he means business, on Monday declaring a "national emergency" at the southern border, announcing immediate deportation raids, reinstating his "Remain in Mexico" policy, and designating drug cartels as foreign terrorist organizations. His unexpected (and probably illegal) order to deny birthright citizenship to the children of noncitizens signals just how far he's willing to go to deliver on this campaign promise. While we won't see the 15 million deportations Trump threatened on the campaign trail (there may not even be that many undocumented immigrants in the US), with committed immigration hawks like Stephen Miller and Tom Homan running the show, the administration could remove up to 1 million people this year and perhaps 5 million over his term.

That's a problem for the economy because the labor market is operating at full employment. Removing millions of existing workers (who are also consumers and taxpayers) while curtailing immigration will shrink the US workforce, driving up wages, business costs, and consumer prices, reducing the economy's productive capacity, and widening the deficit.

The combined effect of Trump's trade and immigration policies will be slower growth and higher inflation. And the two pro-growth policies that investors and business leaders are banking on – deregulation and tax cuts – won't deliver enough juice to offset the damage.

Yes, the financial sector, Silicon Valley, the crypto industry, and fossil-fuel producers will benefit from lighter regulation. But the macro impact will be limited: The US economy is already among the most loosely regulated in the developed world, and Trump already picked much of the low-hanging fruit in his first term. Domestic energy production reached record highs during the Biden administration, and low oil prices will discourage much additional output and investment this year.

As for tax cuts, Republicans will make permanent Trump's 2017 cuts for corporations and the wealthy at a cost of over $4.5 trillion over 10 years. But with the fiscal deficit already at 6.5% of GDP and only a razor-thin House majority, Trump won't be able to slash taxes much (or any) further without offsetting spending cuts. Even if Elon Musk's now-official Department of Government Efficiency (whose constitutionality is already being challenged in court) manages to find some cost savings and efficiencies in the federal budget, meaningful spending cuts will be hard to come by – especially as entitlements remain untouchable and Trump boosts defense spending.

The result? Trump's promises to lower the corporate income tax rate to 15% and eliminate taxes on tips, Social Security, and overtime pay are likely to go unmet. Yet deficits and debt-to-GDP will grow faster over the next four years, putting upward pressure on America's long-term borrowing costs.

All this – higher inflationary pressures from tariffs and deportations, bigger deficits – will force the Fed to keep interest rates higher for longer to fight inflation, raising your mortgage payments, strengthening the dollar, and further dampening growth. Cue angry tweets from Trump demanding rate cuts, which will spook markets and lead Jerome Powell to double down on demonstrating the Fed's independence.

Many business leaders and investors are shrugging off these risks, remembering how well the economy performed in Trump's first term and believing the president will back down or be constrained from following through on his most disruptive campaign promises.

But the starting conditions are very different than in 2017. Corporate valuations are much higher. Government debt has exploded since the pandemic, and deficits are structurally higher. Inflation is still above target, and interest rates remain elevated. The downside risks are significantly greater. More importantly, Trump 2.0 is not Trump 1.0. Not only does the president have unified government and an iron grip on his party, but he's also consolidating executive power and assembling a more personally loyal team ready to implement rather than block his agenda.

To be sure, many of his tariff threats will prove to be bluster. Logistical and political roadblocks will limit the scale of deportations. Lobbying from CEOs and advisers like Musk might temper his most disruptive impulses. And a large enough market selloff or $15 eggs before the midterms could convince him to soften a long-held position.

But make no mistake: Trump will follow through on his agenda to a greater extent and with a steeper cost than most seem to realize. And the constant guessing game about what the president might do next will itself weigh on trade, investment, and growth.

Over time, this structural uncertainty and policy volatility – combined with the cronyism and pay-for-play that will flourish during Trump's transactional presidency – risks eroding the foundations that have made America the world's premier economy.

From the WP's Catherine Rampell:

Trump finds a new way for foreign governments to pay him off: Crypto

Trump's crypto coin is little more than a whizbang Ponzi scheme.

January 21, 2025

The era of the Shakedown Economy has officially begun — and it started with something called a presidential "sh--coin."

No, I am not making this up.

Two days before his inauguration, Donald Trump abruptly launched a new cryptocurrency, traded as "$TRUMP." For those unfamiliar, this kind of crypto token or "memecoin" is released and traded on public markets, sort of like a stock. Unlike stocks, however, memecoins have no cash flow, no fundamental value. There's no claim to a business's future profits, nor even the pretense of a business model. There's no clear use case; no one is pretending $TRUMP will be used in real-world transactions to pay for groceries or a haircut, or to send remittances.

Rather, people buy memecoins such as $TRUMP solely because they think someone *else* might be willing to pay more for them someday. It's basically a whizbang-sounding Ponzi scheme.

Memecoins (also commonly referred to by that scatological nickname mentioned earlier) originally began as a joke — a commentary on the wildly speculative nature of crypto, invoking some existing internet meme.

Among the best-known memecoins are "dogecoin" (named for an internet-famous Shiba Inu) and "Fartcoin" (probably self-explanatory). Today Fartcoin has a market cap of nearly $2 billion.

Again, not making this up.

The Trumps have been trying to get into crypto for a while, and they saw an opportunity to cash in this weekend. Just as Trump sold his MAGA devotees Trump-branded Bibles and sneakers, he has now sold them a Trump memecoin. Of course, if someone pays $60 for a Trump-branded Bible, they may have overpaid, but at least they got a holy book in exchange; if you lose all your savings on Trump's memecoin, you have nothing to show for it.

Hopefully at least some buyers are purchasing the coins with their eyes open, to show their support for Trump. And the good news for those who bought $TRUMP early is that the token has shot up in value. It rose from an initial price of about $6 to roughly $75 overnight, before dropping when the family double-dipped with the launch of a second memecoin ("$MELANIA"). As of Monday afternoon, $TRUMP was trading around $40, which is still an enormous gain.

Trump insiders own about 80 percent of the tokens, which means on paper they have made tens of billions of dollars for doing precisely nothing. Even without needing to sell a single coin from their reserve, on the first day the Trump team banked an estimated $58 million on trading fees alone.

The challenge now for anyone who bought these coins is that if they want to cash out, they have to find a greater fool willing to pay more. Will there always be someone willing to buy these magic beans? Probably not. So a lot of unsophisticated traders are likely to lose their shirts on a terrible bet. In other words, Trump has made these latest billions by fleecing his biggest fans.

On the other hand, $TRUMP owners' losses might be somewhat limited, for an unusual reason. For the next four years, there may be one reliable source of ongoing $TRUMP buyers: individuals, companies and foreign governments that want to curry favor with the president.

This memecoin has now become the easiest, most convenient way to do that. The Saudis no longer need to stay at one of Trump's hotels — or merely pretend to — to line the president's pockets; they can flash their digital wallet to show how much they've boosted his net worth.

After all, every dollar they put into propping up the value of Trump's memecoin will effectively add cash to Trump's bank account, emoluments clause be damned.

Kind of hilariously, even the usual crypto boosters are aghast and have decided that Trump's memecoins are way too scammy even for them. Some have also pointed out red flags indicating possible insider trading going on with $TRUMP tokens, similar to the scandal plaguing another notorious memecoin (one named after an oral-sex joke that I'll spare you).

In theory, government regulators could put some safeguards in place — perhaps to protect unsophisticated retail buyers, or wall off certain parties from participating in transactions that would enrich the president without disclosure. But obviously the president now controls crypto regulation. And Trump seems unlikely to appoint regulators who will protect markets from, well, himself. At the very least, he has promised to deregulate the crypto industry more broadly.

Meanwhile, $TRUMP insiders appear to already be transferring some of their tokens to an overseas trading platform that is not allowed to execute trades in the United States. Perhaps they're positioning themselves to stand outside the U.S. government's reach anyway.

During his inaugural speech Monday, Trump complained that "for many years, a radical and corrupt establishment has extracted power and wealth from our citizens." Perhaps his objection was that the old establishment simply wasn't tech-savvy enough.

The first of three from the WSJ was published on Jan 22nd:

"What Time Is It? What Time Is It?"

By Jason Zweig

Fellow investors,

Years ago, I had the good fortune to meet George J.W. "Jerry" Goodman, who wrote brilliantly about investing under the pen name 'Adam Smith.'

Fluent in Greek and Latin, with experience as a professional money manager, he probably wrote more wisely and wittily about investing than anyone else except Benjamin Graham and Graham's greatest student, Warren Buffett.

Whenever markets feel euphoric -- like, say, right now! -- I'm always haunted by a paragraph Goodman wrote in the late 1960s, during a mania that came to be known as "the great garbage market." Here it is, as published in his 1972 classic book Supermoney:

> We are all at a wonderful ball where the champagne sparkles in every glass and soft laughter falls upon the summer air. We know, by the rules, that at some moment the Black Horsemen will come shattering through the great terrace doors, wreaking vengeance and scattering the survivors. Those who leave early are saved, but the ball is so splendid no one wants to leave while there is still time, so that everyone keeps asking "What time is it? What time is it?" but none of the clocks have any hands.

'Adam Smith,' *Supermoney* (John Wiley & Sons, 2006 reprint of 1972 edition), p. 78

I'm not saying that the bull market is about to end. However, you should always seek to take the other side of the trade from the market's dominant emotion. As other people verge on ecstatic, you should become more skeptical.

After decades of learning about market booms and busts throughout history, it seems to me that one of the universal laws is that the smarter investors are, the more they believe they're smart enough to scale back on an overvalued market before it's too late.

They think that by constantly asking "What time is it?" they're learning whether there's still time to make money.

What they should be reminding themselves, before it really is too late, is: But none of the clocks have any hands.

What You Don’t Know Could Sting Your Portfolio

After all my years of writing about investing, I had no idea what was going on behind the scenes. I doubt you did, either.

By *Jason Zweig*
Jan. 17, 2025

Your financial adviser may have a conflict of interest that you would never even think to ask about.

Advisers are required by law to act in your best interest. They can sometimes be pushed to do otherwise, though. The latest push comes from an unlit corner of the financial industry, and you need to know about it so you can guard against it.

To see what I mean, consider what recently happened to Mark Armbruster, chief executive of Armbruster Capital Management, a financial adviser in Pittsford, N.Y. His firm manages about $900 million, mainly for individual investors.

As an investment adviser, Armbruster needs to safekeep its clients’ assets at qualified custodians—the firms that process trades, maintain records, and generate account statements and tax reporting. Custodians are often divisions of financial giants like Fidelity Investments or Charles Schwab.

Late last year, according to Armbruster, a Fidelity custody representative said the financial-advisory firm needed to generate at least $90,000 more in annual revenue.

In an email, the Fidelity representative spelled out seven ways Armbruster could make up the shortfall. Several involved what the rep called “asset shift,” or moves into investments run by Fidelity affiliates—which would generate more revenue for the giant firm regardless of whether they were the best option for Armbruster’s clients.

In one asset shift, Armbruster could move about $3 million out of high-yielding money-market funds into Fidelity’s FCASH fund, lately yielding 2.19%. It could move roughly $35 million into other money-market funds run by Fidelity. Or it could move about $80 million out of fixed-income index funds run by other managers into a more expensive bond fund actively managed by Fidelity.

Each of those moves would make Fidelity a little bit more money, thanks to lower payouts or higher fees. And they would likely make Armbruster’s clients a little bit less money.

After all my years of writing about investing, I had no idea this sort of thing was going on behind the scenes, and I doubt you did, either.

Fidelity is a firm I've long admired, but this is the opposite of how investment advice should work. Your adviser's job is to get you the highest after-tax return at a given level of risk for the lowest possible cost. What matters is whether an investment is right for you—not whether it happens to be more profitable for the firm that has custody of your assets.

The "asset shifts" that Fidelity suggested, says Armbruster, would mean some of his firm's clients might incur trades that could generate taxable capital gains. Worse, the moves would be motivated not by what was in the best interests of Armbruster's clients, but by Fidelity's revenue targets for itself.

"They're asking us to breach our fiduciary obligations to our clients, which is disturbing and egregious," says Armbruster. He refused to consider making any of the "asset shifts."

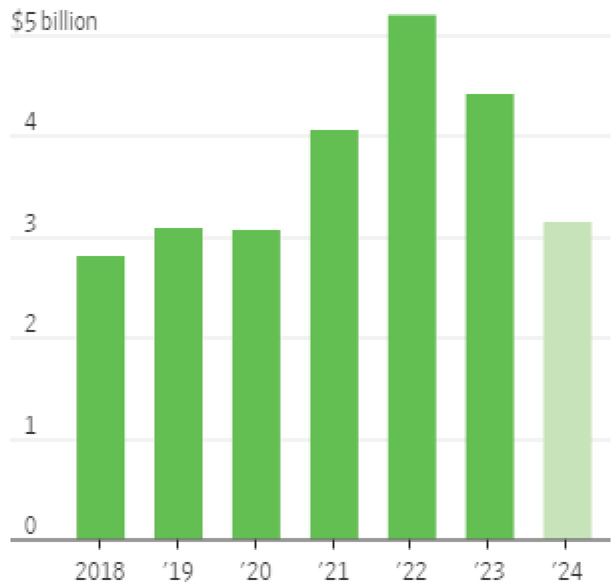
"Fidelity does not require wealth-management firm clients to take any one specific course of action, and several options are provided to all [such custodial] clients," said a senior Fidelity custody executive in response to my inquiries. "Ultimately, all investment-related decisions are the adviser's, to be made in the best interests of their end-customers."

Note that you aren't the custodian's client; your adviser is. Although your adviser needs to act in your best interest, the custodian doesn't.

Still Safe, But Less Lucrative

Safekeeping, or custody, revenue generated by financial advisers (as indicated by Schwab's advisor-services division) has been declining from its recent peak.

Charles Schwab net revenues from custody and related services



Note: 2024 data through Sept. 30
Source: the company

Michael Kitces, who analyzes the financial-advisory industry at kitces.com, says these conversations about extracting more revenue are happening with "increasing regularity and frequency" between many custodians and their financial-adviser clients, especially smaller advisers.

Trading fees and other sources of income for custodians have been declining for years. "So the custodians are saying to [advisers], 'Please do more of the moneymaking things for us,'" says Kitces. "That's gotten significantly more problematic and challenging over the past few years, and it highlights the pernicious nature of hidden conflicts of interest."

The Fidelity custody executive says that it's standard practice for the firm to provide advisers with access to all available investment choices and that the interactions with Armbruster came early in what is meant to be an ongoing discussion. Fidelity doesn't encourage its account representatives to share exact revenue targets with the financial advisers who use its custody services, he says.

Another option Fidelity gave Armbruster was an annual custody fee of $375 per account (or a firmwide fee yet to be determined).

That option, which Fidelity says is "standard" to present to advisers, at least makes the cost of custody explicit. I wouldn't have a problem with that. The custodian is entitled to make a profit. An adviser could pay the custodial cost, then raise its own fees to make up for it. Or each of the adviser's clients could pay it directly to the custodian.

What bothers Armbruster and me is the idea of paying custodial costs by moving money to investment options that advisers might not otherwise favor.

You need to ask your financial advisers if any of their recommendations are swayed by what's most lucrative for the custodian. (Not in HCM's case.) And custodians should charge for their services exclusively through explicit, transparent fees. That way, advisers wouldn't feel pressured to act in the custodians' best interest instead of your own.

Your Fancy, New ETF Might Be a Little Too Fancy

Exchange-traded funds have mostly been great investments, but they are getting too complex for their own good

By *Jon Sindreu*
Jan. 7, 2025

History teaches that financial complexity always creeps upward. Lately that trend has reached investor-friendly exchange-traded funds.

Last year, U.S.-based ETFs broke a record, surpassing $1 trillion in total inflows. They are cheap, liquid and, crucially, far more tax-efficient than traditional mutual funds. If you want to hold stocks and bonds, the flagship trackers from industry giants BlackRock BLK 0.08%increase; green up pointing triangle, Vanguard and State Street Global Advisors already do the trick for very low fees. It is tough, and not especially rewarding, to compete with those industry behemoths head-on.

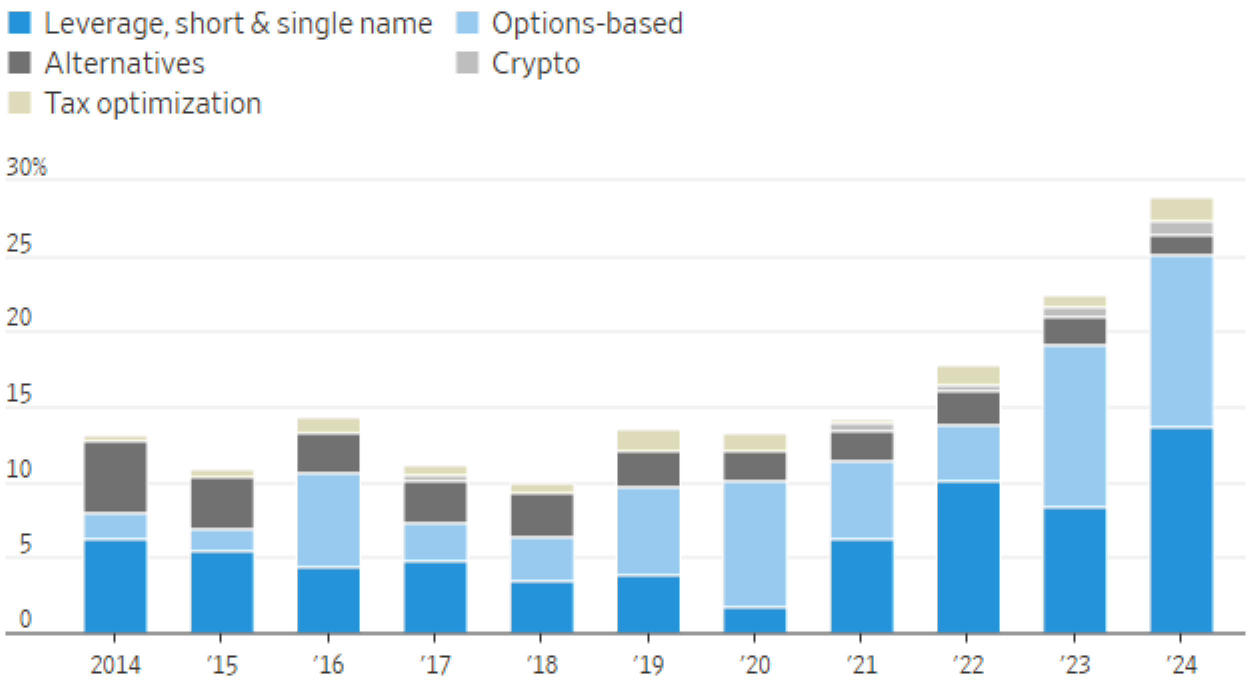
So Wall Street has found a new gold rush: packaging even the most sophisticated products in ETF form. About 30% of ETFs launched in the U.S. in 2024 referred to some complex strategy in their names, an analysis of Morningstar Direct data suggests—double the average of the previous nine years. What it says on the label is becoming increasingly creative, and what happens inside of those funds is increasingly obscure.

That complexity sometimes delivers a poor return compared with the plain vanilla variety. After a dismal December, the Simplify Enhanced Income ETF—trading under the ticker HIGH—ended 2024 with a total return of 1.5%, despite its prospectus saying that "it seeks to provide significant supplemental income to T-bills." The SPDR Bloomberg 1-3 Month T-Bill ETF, or BIL, returned 5.2%.

In addition to buying short-term paper, HIGH buys and sells "call" and "put" options to generate extra income, which amount to insurance policies against rises and falls in the price of some underlying asset. But this can create big losses whenever market volatility jumps, as happened in August and October. HIGH has the flexibility to venture into terrain such as the S&P 500, Nasdaq-100 and Russell 2000 indexes, and even gold ETFs.

Beating T-bills when interest rates are at 4.5% is no easy task, and HIGH has been making some risky bets. Its options contracts on the S&P 500 maturing this Friday, for example, will only yield a gain from here if the index rises more than 0.6% or falls more than 7.9% from Monday's close by expiration. The fund even traded

New ETFs with the following references in their names, as a percentage of total ETF launches

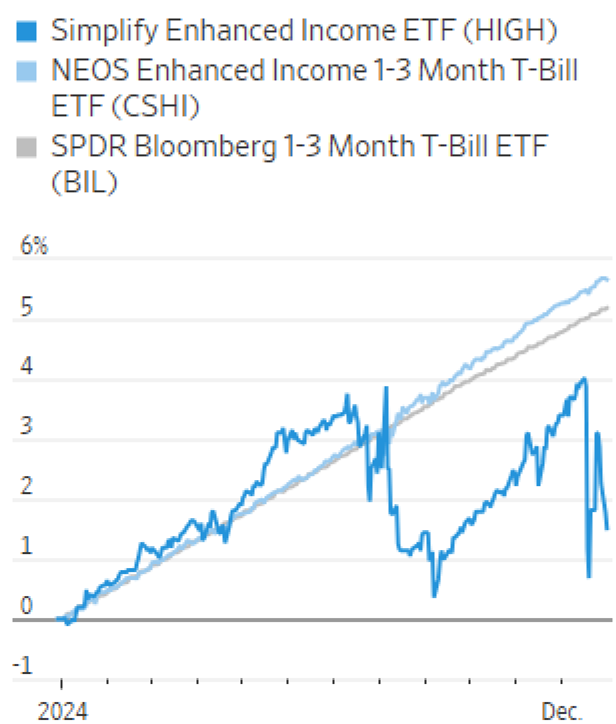


Sources: Morningstar Direct, WSJ calculations

options on MicroStrategy MSTR -4.11%decrease; red down pointing triangle, the speculative bitcoin-buying machine, which fell 25% in December.

The similar NEOS Enhanced Income 1-3 Month T-Bill ETF, ticker symbol CSHI, managed to deliver a 5.7% return in 2024 by sticking to less-risky put options. The point, though, is that any product exposed to big drawdowns isn't a good alternative to cash, which is the typical use case for short-term bond ETFs.

Cumulative total return



Source: FactSet

Or take the JPMorgan Equity Premium Income ETF, or JEPI, and its Nasdaq-focused sibling, JEPQ: They received $5 billion and $11 billion in net inflows in 2024, respectively, putting them on par with the top U.S. equity ETFs. While their options-based strategies reduce volatility from owning stocks, they also cap the upside, are easy to front-run, are tax inefficient and don't shield against big selloffs. Arguably, they are products that almost nobody needs.

Even those offering investors the ingredients to shoot the lights out often wind up shooting them in the foot. The ProShares UltraPro QQQ, a $27 billion behemoth that promises to triple the daily return of the Nasdaq-100, has barely generated any return over the past three years as the technology-heavy index soared.

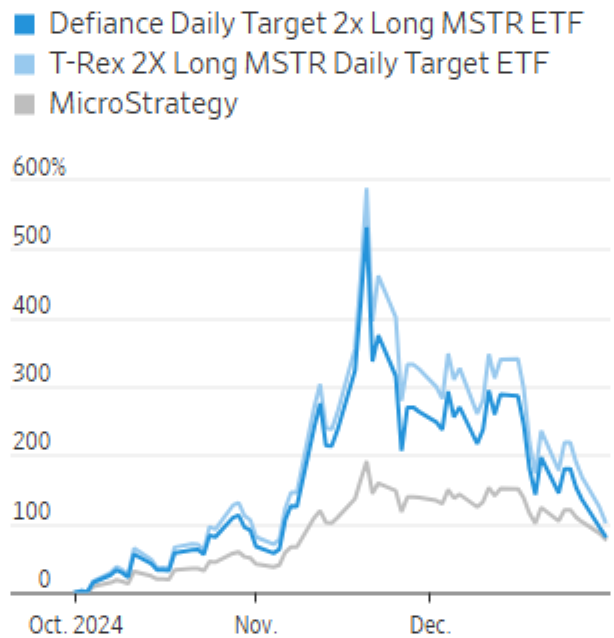
The issue with it and dozens of similar funds is that leveraged ETFs are usually reset daily. Each loss therefore reduces the base for future gains more than for the index, which measures returns cumulatively.

Since 2022, financial firms have been launching leveraged ETFs that target single companies, making this problem more egregious. Once again, MicroStrategy pops up: The Defiance Daily Target 2X Long MSTR ETF and the T-Rex 2X Long MSTR Daily Target ETF aim to amplify the returns of the stock but have barely done so, often missing even their daily targets.

The next frontier is building ETFs that replicate other assets without some of their undesirable characteristics.

The Alpha Architect 1-3 Month Box ETF, or BOXX, for example, tries to match or surpass T-bill returns with options so as not to trigger taxable distributions. Still, it was forced to do one last year under counsel from its legal advisers.

Cumulative total return



Source: FactSet

There is also demand to access so-called alternative assets in a cheaper, easier way. The University of Connecticut's endowment recently replaced most of its hedge-fund holdings with "buffered ETFs," which also offer some protection in down markets. Products such as the IQ Hedge Multi-Strategy Tracker ETF explicitly try to copy the performance of hedge funds without owning any.

In December, both BondBloxx and Virtus Investment Partners launched the first ETFs providing exposure to private debt, although in the form of relatively mainstream collateralized loan obligations. State Street Global Advisors has filed an application with U.S. regulators to launch an ETF that would invest a portion of its money in this illiquid form of credit directly. Its approval is uncertain because putting a liquid wrapper around less-liquid assets comes with obvious dangers.

Of course past innovation in ETFs has led to predictions of trouble that have time and again proved unfounded. In 2020, when corporate-debt markets froze, ETFs became a way to keep markets liquid during trying times.

Yet, by their very nature, financial markets will eventually push one too many complex features into ETFs. Perhaps it will happen to this recent crop of products, leaving holders with a mix of losses in cash-like funds, stranded private assets and ill-conceived tax strategies that prompt angry calls from the Internal Revenue Service. The tipping point could still be years away.

Regardless, investors need to be increasingly cautious about what they buy and who they buy it from. These are the times that will test ETF builders.

Follow-ups

From Bloomberg:

Stock Bears Are Going Extinct. Time to Worry?

Strategists who got 2023 and 2024 wrong are extrapolating equity market strength into 2025. Recency bias can mislead.

January 2, 2025

By Jonathan Levin

Jonathan Levin is a columnist focused on US markets and economics. Previously, he worked as a Bloomberg journalist in the US, Brazil and Mexico. He is a CFA charterholder.

It’s that time of year when Wall Street soothsayers look ahead 12 months and try to divine the path of US stocks. Last year at this time, no one writing for a major sell-side firm thought stocks would perform anywhere near as well as they did, up 23% in 2024.The median prognosticator thought we would probably move sideways, and a few bears were calling for a meaningful selloff. The same was basically true of the forecasts the year before that. In retrospect, that failure of imagination almost looked like a contrarian bullish sign.

In any case, something has clearly changed in Wall Street’s mindset. This year, the median strategist expects the S&P 500 Index to end 2025 at 6,600, an implied upside of 12% at the time of writing. The more bullish strategists of recent years have been emboldened, while the erstwhile bears have mostly been converted (this year’s tally offers just two strategists predicting a destination below 6,000, among them only one uber bear, Peter Berezin of BCA Research). Given the extraordinary two-year run in the S&P 500, this development seems natural, though it also points to new investor perils for the year ahead.

From a behavioral perspective, it all smells a lot like recency bias, the tendency to let recent events hold outsize influence over our views of the future. But there’s also a rational, real-world basis for the sunnier outlooks, and it would be a mistake to dismiss it as pure psychology.

The generative artificial intelligence buzz of 2022 has proved much more than flash-in-the-pan hype, yielding hundreds of billions in capital expenditures and, for Nvidia Corp., a previously unimaginable run of revenue growth. More broadly, the success of the Magnificent 7 growth companies has transformed the way that sellside strategists view their jobs. At 33% of the S&P 500 by weight, any outlook has to incorporate a detailed vision for the future of those companies: Apple Inc., Microsoft Corp., Nvidia, Amazon.com Inc., Meta Platforms Inc. and Tesla Inc. In most cases, they have become diversified, dominant and efficient cash-generation machines the likes of which US investors have rarely encountered in their lifetimes. (Tesla is something of its own case, with a valuation driven more by a narrative than real profits. Yet Chief Executive Elon Musk has President-elect Donald Trump’s ear, a competitive advantage that’s essentially priceless.)

In addition to the Mag 7, the US economy has emerged as a singular powerhouse among developed markets. The economy has strung together productivity-driven growth unlike anything since the early 2000s, and that’s kept consumption and labor market numbers favorable despite countless doomsday predictions. Miraculously, inflation has ebbed at the same time.

Granted, there are new risks that come with the territory. First, when everyone has bought into the bullish story, who's left to invest and push up prices? I doubt we've reached a point of investor saturation, but we may be

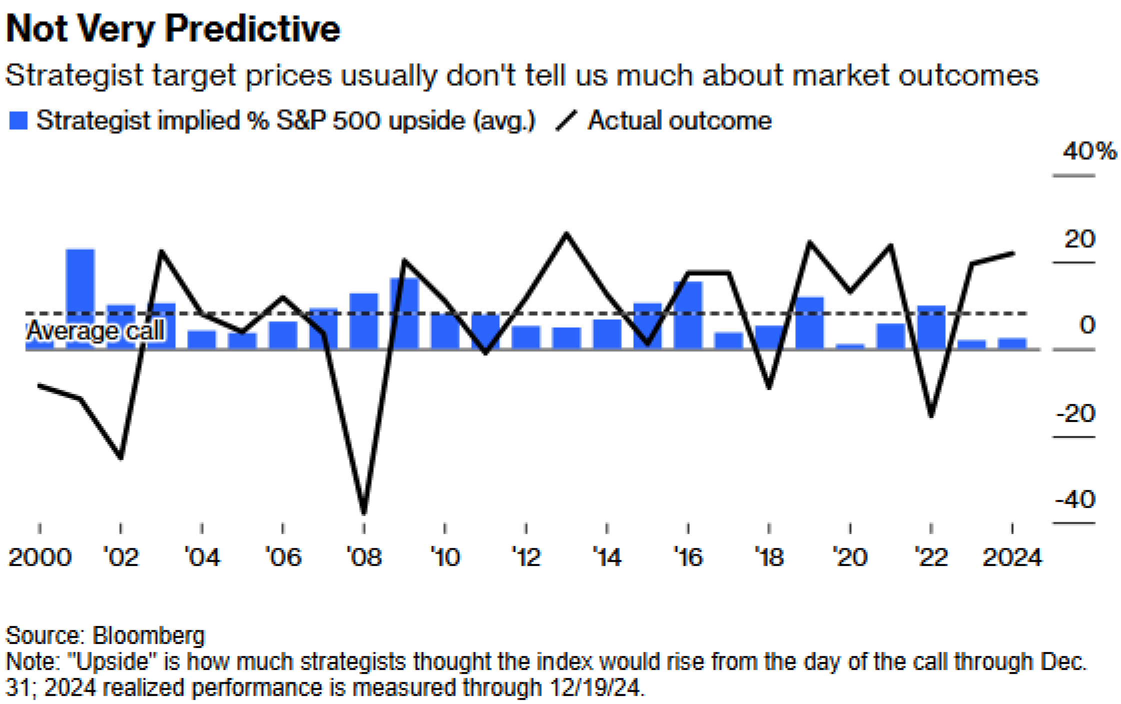
Sunny Outlook

Strategists that missed the 2024 gains turned bullish for 2025

Firm	Target
Bank of America	6,666
Barclays	6,600
BCA	4,450
BMO	6,700
BNP Paribas	6,300
Cantor Fitzgerald	6,000
Citigroup	6,500
CFRA	6,585
Deutsche Bank	7,000
Evercore ISI*	6,600
Fundstrat	6,600
Goldman Sachs	6,500
HSBC	6,700
JPMorgan	6,500
Morgan Stanley*	6,500
Natixis	6,700
Ned Davis Research	6,600
Oppenheimer	7,100
RBC Capital Markets	6,600
Scotiabank	6,650
Societe Generale	6,750
Stifel	5,500
UBS	6,400
Wells Fargo	7,007
Yardeni	7,000
Median	**6,600**
75th percentile	**6,700**
25th percentile	**6,500**

Source: Bloomberg
Note: For completeness, this table includes some additional firms that aren't part of the time series data referenced in the chart below; data aggregated as of 12/11; *Evercore target is for mid-year and Morgan Stanley's target is for 12 months out.

getting a bit closer. Second, everyone's portfolios have become overly concentrated in those same "Mag 7" stocks, and their valuations have drifted higher to the point that they're already discounting many of the companies' superpowers. The analysts that cover them estimate that their growth prospects have moderated from extraordinary to simply great. You would still need some catalyst to trigger a selloff — a rebound in inflation; an intensifying US-China trade clash; or the onset of an artificial intelligence “winter,” for instance — but the risk is impossible to discount completely.



BCA’s Berezin, the most bearish strategist in data compiled by Bloomberg, based his market prediction on the expectation of a US recession. Among other things, he said that Trump could spark a trade war that weighs on business investment, and he warned about the potential outbreak of a “bond market riot” against deficit-funded tax cuts. In Berezin’s scenario, those events could collide with an economy where credit card and auto loan delinquencies are already on the rise. “I’m not a perma-bear; this is really the first time in my career that I’ve been really outspoken bearish,” Berezin told me. “The market needs to hear a more sober bearish voice, because they’re so rare these days.”

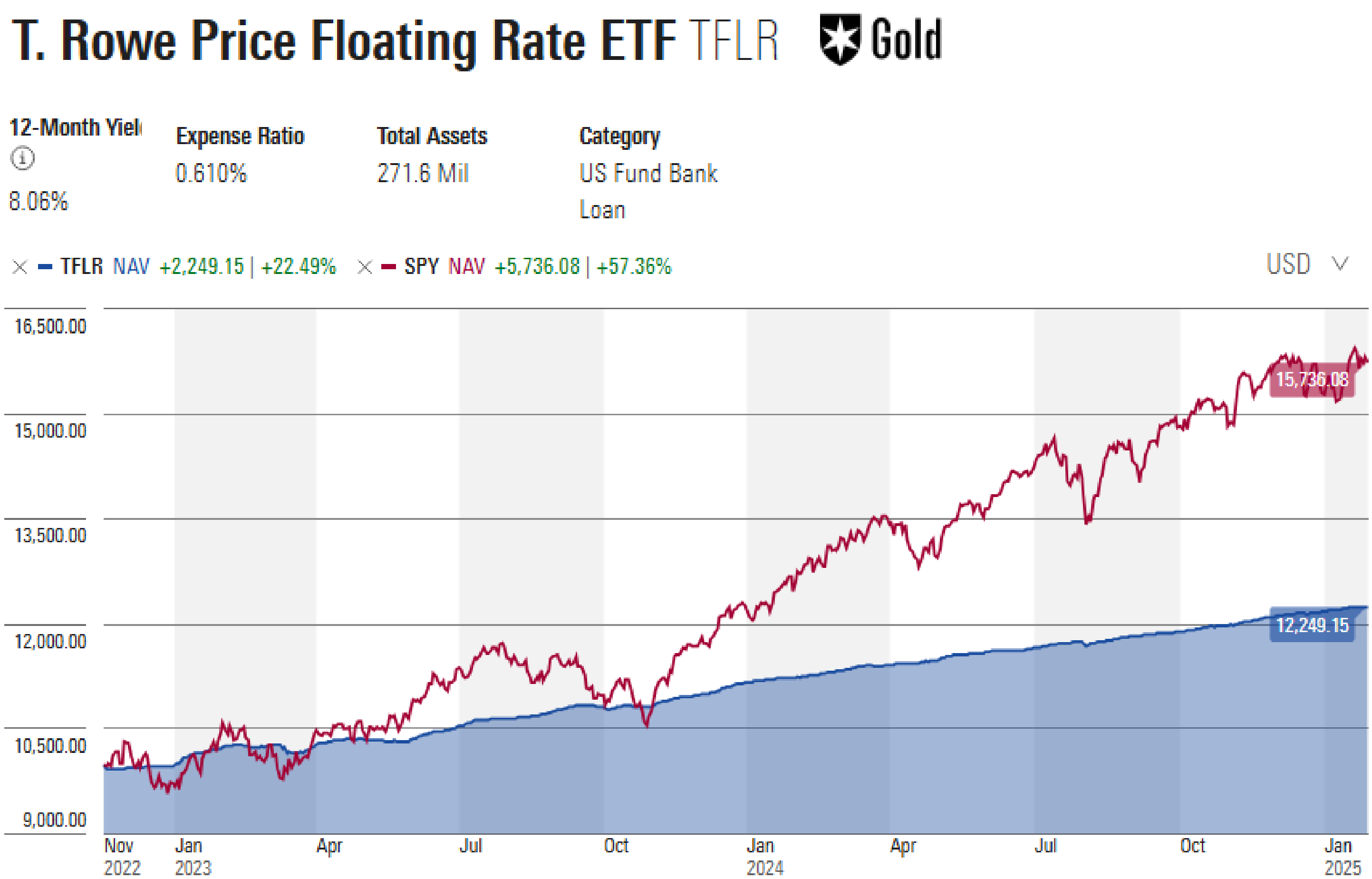
As I’ve written before, it’s important to recognize 12-month stock projections as the educated guesses that they ultimately are. Strategists have rightly learned that stocks usually go up, and the average outlook in Bloomberg data is *always* positive. But the average point estimate is rarely particularly insightful and frequently proves a total flop.

As examples, strategists on average were relatively bullish throughout the dot-com bust and ahead of the 2008 financial crisis. More recently, they expected a relatively good year in bear-market 2022 and failed to foresee the go-go years of 2023 and 2024. Go figure. Strategists just don’t have crystal balls, and they sure can’t predict recessions or pandemics. They’re a collection of fallible humans trying to deliver on an impossible task. That doesn’t mean they aren’t insightful, and I remain an avid consumer of their prose, especially their ideas on risk management, asset allocation and emerging investing themes. As for the targets themselves, they’re mostly just a piece of the broader market-sentiment puzzle.

Given everything, the logical answer is to stay invested but hedge your bets with some combination of bonds, options and less volatile US equities. Stocks usually go up, and there’s still a lot to like about the setup for 2025. But if there’s one thing that the past couple of years has shown us, it’s that the market is always capable of doing the unimaginable, so we should keep our wits about us.

Positions

During the month of January we sold all positions in 2 stocks (KMI & MPLX), and 4 funds (FRIFX, MTUM, OMFL & WCMSX), all of which had gains, to rebalance, and lower the **Risk Ratio** relative to the S&P 500 (SPY) for all clients. All clients now have approximately a 10% position in TFLR, with the remaining excess cash in MINT. From Morningstar:



Paul Olmsted Senior Analyst

Summary

T. Rowe Price Floating Rate ETF's experienced manager, risk-aware approach, and strong decisions make this a compelling actively managed bank loan ETF option. However, its November 2022 inception is a short period to assess this vehicle on its own. While the ETF is managed in line with the T. Rowe Price Institutional Floating Rate Fund RPIFX. positioning and other risk factors may differ during the ramp up period. As such, the analysis reflects the longer-term history of the open-end fund.

Paul Massaro, the sole manager on the strategy, brings over 23-years of experience and draws on robust resources. Named to the fund in May 2009, he rose up to assume the head of T Rowe Price's high yield and bank loan platform in 2021. Massaro has built a formidable crew; he leans on two-decade bank loan veteran and manager, Stephen Finamore, a 20-person fundamental credit research team, six traders, and two quantitative analysts.

These credit researchers provide key input to the process with their diligent, fundamental research, and relative value recommendations that drive portfolio decisions. The research team that averages more than 14-years of industry experience assigns internal credit and conviction ratings from one (highest) to five (lowest), with a focus on improving credits. This highly collaborative, relative value approach that includes input from the entire team informs overall portfolio construction.

This collaboration focuses on corporate fundamentals and relative value opportunities with an emphasis on BB and B rated loans while being selective within CCC rated and second lien loans. Strong relative valuations in CCC rated and below loans led the team to increase this stake to nearly 10% of assets (as of December 2023) from 6.3% the beginning of 2020. The team's access to some of these harder-to-source deals, such as second lien loans, through strong private equity sponsor relationships helps enhance this edge. Sensible guidelines encourage fund diversification, but the team invests more in higher conviction issuers; for example, the fund's 15 largest holdings made up about 29.5% of assets compared to about 6.5% for the same issuers in the Morningstar LSTA Leveraged Loan Index.

Effectively managing these various risk exposures has led to compelling long-term performance. Since manager Paul Massaro took the sole reins in May 2009, the Institutional shares' 5.8% annualized return through January 2024 beat its unique bank loan Morningstar Category median peer's 5.5% gain, and its results over five- and ten-year trailing periods ranked among the category's best. Diligent security selection, a proven ability to eschew most defaults, and effective risk management was key to this strong result. Avoiding the riskiest issuers has helped dampen volatility and, as such, has suffered less than most peers in market selloffs, at the cost of less spectacular returns during rebound periods.

Process High

T. Rowe Price's managers and asset allocation committee begin the process with their monthly top-down views that inform their desired risk levels for the fund. The key here is diligent, holistic credit selection where the sector specialists actively screen the universe, eliminate small and less liquid loans, and then assign proprietary ratings and conviction scores from one (highest) to five (lowest), with a focus on improving credits.

Sensible portfolio guidelines help manage overall risk and ensure adequate diversification but also give manager Paul Massaro enough leeway to express high conviction ideas. Industry exposures normally stay within 5 percentage points of the weightings of the Morningstar LSTA Leveraged Loan Index; but individual issuer exposures can be quite concentrated. As of year-end 2023, the fund's 15 largest holdings made up about 29.5% of the fund's assets compared to about 6.5% for the same issuers in its benchmark.

Daily communication and idea-sharing underpin the fund's consistent process. Research analysts are also responsible for relative value recommendations on their issuers and industries which requires a broader understanding beyond their respective sectors. Security selection in BB and B rated loans drive performance here but the fund may delve into CCC rated or second lien loans of high conviction issuers. Layering cash and more-liquid securities as a buffer to this less-liquid asset class ensures ample liquidity.

BB and B rated loans make up the portfolio's foundation, but manager Paul Massaro will opportunistically own CCC rated and second lien loans. For example, its CCC rated and below stake rose to nearly 10% of assets as of December 2023 from 6.3% the beginning of 2020, while second-lien loans with strong covenant packages made up 11.6%. The team has enhanced its access to some of these harder-to-source deals through stronger private equity sponsor relationships.

Massaro also expresses his views through industry over- and underweights. The strategy’s largest industry overweightings versus the Morningstar LSTA Leveraged Loan Index include financials, where they favor insurance brokers, and entertainment and leisure, consistent with their positive economic outlook; these represent 6.4- and 3.4-percentage point overweightings, respectively, as of December 2023. Massaro’s caution on the ability of healthcare issuers to manage higher labor costs led him to reduce exposure to the sector by more than 3 percentage points over 2023. The fund’s other meaningful underweighting includes service companies. Information technology rose to neutral weight on a positive outlook for software companies with strong revenue models; this stake represented a 2.8 percentage point underweighting a year ago.

The strategy has largely avoided defaults with its since-inception: its portfolio shows a 0.1% average annual default rate through 2023 compared to 2.6% for the benchmark.

People High

While Massaro is the only named manager here, the strategy requires a team effort. He brings more than two decades of investment experience to the strategy and began his T. Rowe Price career in 2003 as a high yield analyst. From there, Massaro rose to portfolio manager in 2008 and eventually took over as the head of the firm’s high yield and bank loan franchise in 2021. Another bank loan veteran, Stephen Finamore, works alongside Massaro to help make portfolio decisions; although not formally named on this fund, Finamore’s 23-years of experience gives the strategy another capable hand and lessens key person risk; he joined the floating rate team in 2013 and manages bank loan separate accounts.

The team draws on ample and capable supporting resources, including a 20-person dedicated high yield and bank loan research team that averages more than 14 years’ experience, six traders, and two quantitative analysts. They also stand out from peers by regularly accessing the firm’s large stable of equity analysts for capital structure perspectives and company-specific insights.

This stable team has hasn’t had any recent material departures and only modest turnover within the credit research and trading teams. Two experienced research analysts left in 2022, yet the firm easily backfilled those roles with a mix of experienced and newer analysts and even netted an additional researcher to the team over the year.

Massaro’s personal investments in the strategy exceed $100,000.

Adam Sabban Senior Analyst

Parent High

Equities remain the firm's largest business unit and a key area of strength, bolstered by capable portfolio managers and a deep bench of well-regarded analysts. Most equity assets are housed in mutual funds, and although the firm was slower than some peers to diversify into other vehicles, it is making up ground with new products such as transparent ETFs. While the equity franchise has suffered outflows partly because of the growing popularity of passively managed options and competitors' active ETFs, its many appealing strategies should help it endure.

Offsetting some of the equity unit's business challenges is its highly successful multi-asset franchise, which continues to grow. That division represented one third of the firm's roughly USD 1.5 trillion in assets under management as of March 2024. The firm's target-date offerings and tactical-allocation funds remain best-in-class. The fixed-income effort has some bright spots, such as municipal-bond and credit-sensitive strategies, but it hasn't delivered in others, such as core bond. New leadership of that unit, along with increased hiring to bolster its nascent risk department, should help improve that side of the business.

Performance

The Institutional shares' 5.8% annualized return through January 2024 beat its unique bank loan Morningstar Category median peer's 5.5% gain. Its results are more impressive when adjusting for risk; the fund's Sharpe ratio (a measure of return relative to standard deviation) was among its peers' top quintile over the same period. Over five-and ten-year trailing periods, the fund's absolute and risk-adjusted returns rank among the category's best.

Diligent security selection, low historical defaults, and effective risk management have led to consistent performance. This team relies on its ability to avoid the riskiest issuers and structures has helped to dampen volatility. As a result, the strategy tends to look median-like during rebound periods but has suffered less than most peers in market selloffs. During 2020's pandemic-driven first quarter selloff, for example the fund's 10.2% drawdown was less severe than more than 75% of peers, but its 1.9% calendar year gain only kept pace with the category norm. However, during the calendar year 2022, marked by heightened volatility and rising yields, strong security selection in information technology, financials and healthcare helped this fund's 0.6% loss hold up better than its typical peer's 2.0% drop.

The fund's 12.5% gain in calendar year 2023 was slightly above median, but it did so with lower volatility than peers. Key contributors over the past year were sector and security selection in BB and B rated paper but offset by underperformance in B-minus rated loans.

Price

Based on our assessment of the fund's People, Process, and Parent Pillars in the context of these expenses, we think this share class will be able to deliver positive alpha relative to the category benchmark index, explaining its Morningstar Medalist Rating of Gold.

PIMCO Enhanced Short Maturity Active ETF MINT ★★★ Gold

12-Month Yield	Expense Ratio	Total Assets	Category
5.20%	0.350%	12.3 Bil	US Fund Ultrashort Bond

Paul Olmsted Senior Analyst

Summary

The combination of veteran leadership, strong collaboration, and a time-tested process makes Pimco Enhanced Short Maturity ETF a top selection among ultrashort bond peers. This exchange-traded fund's mandate is more constrained than its sibling Pimco Short-Term.

Lead manager Jerome Schneider heads a deep team of dedicated ultrashort specialists. He remains the face of the firm's short-term strategies, yet Schneider relies on comanagers Andrew Wittkop and Nate Chiaverini, Pimco veterans whose specialties in rates and derivatives, and corporate credit, respectively, complement each manager's strengths. Effective collaboration is key to the strategy's success, and the addition of these comanagers in July 2021 created depth and alleviated key-person risk with Schneider. The team does not lack resources and draws on Pimco's extensive global investment team of analysts, traders, macroeconomic experts, and risk managers.

The strategy's time-tested process, with a focus on short-term and liquidity markets, stands out. Strong teamwork and consistent inputs further support the strategy's liquidity and capital preservation objectives. The team doesn't hesitate to use its vast global toolkit, which is broader than most peers. The comanagers take their cues from Pimco's macroeconomic forecasts and construct a portfolio with securities that aim to maximize yield and total return potential.

Large corporate and structured product research teams support and inform bottom-up decisions, and the portfolio typically features 70%-90% of assets in investment-grade credit and securitized debt, which contributes to the ETF's yield advantage versus peers. The ETF avoids less conventional areas, such as high-yield bonds, non-US developed markets- debt, and non-US-dollar currencies, but it can invest in emerging-markets debt up to 5% complement its core holdings. In recent years, the ETF has avoided emerging-markets debt entirely. The managers are known to shift the portfolio's duration anywhere between a 0- and 1-year band; while the portfolio widely features derivatives, Pimco has proved its ability to effectively manage these instruments.

The strategy has a strong long-term record. Over Schneider's tenure since December 2019 (his first full month), the US-domiciled ETF's 1.73% annualized gain through July 2024 was slightly ahead of its unique ultrashort bond Morningstar Category median's 1.69%, landing in the second quartile. Adjusted for volatility, its Sharpe ratio was above the median. This approach has generated higher volatility in stressed periods than its typical peer, but its long-term standard deviation is near that of its typical rival.

Process High

Liquidity and capital preservation are paramount. The managers don't hesitate to use its vast opportunity set that is broader than their ultrashort bond competitors. The process begins with cues from Pimco's macro secular forecasts to directionally guide interest-rate, yield-curve, currency, country, and sector decisions. Armed with these inputs, the managers work to build a portfolio with securities that aim to maximize yield and total return potential.

The team draws on managers who specialize in liquidity and a small army of credit and structured product research teams to inform bottom-up decisions, with investment-grade credit and securitized debt making up the lion's share and contributing to the strategy's yield advantage versus peers. While these stakes are common both here and in competitors' portfolios, this strategy also branches into emerging markets debt up to 5% of assets. The ETF, though, avoids less conventional areas such as high-yield bonds, non-US developed markets, and non-US-dollar currencies.

Where competitors may maintain a more static duration (a measure of interest-rate sensitivity), this team doesn't hesitate to use the full range of its 0- to 1-year duration band depending on its outlook; and by avoiding structured bonds with volatile cash flows, this limits unexpected duration extension. Derivatives use is limited to Treasury futures. This modestly adds to the strategy's complexity, but Pimco has proved its ability to effectively manage these instruments and identify mispriced securities between cash and derivatives markets.

MINT is more constrained than its sibling Pimco Short-Term and looks very different from its internal benchmark, the FTSE 3-Month Treasury Bill Index.

Corporates and securitized sectors typically make up 70%-90% of the US-domiciled ETF’s assets, and the team actively manages exposures depending on their outlook for relative value and risk. For example, taking advantage of attractive relative value, the ETF’s investment-grade corporates rose to 54.7% of assets as of June 2024, up from 29% a year ago, while securitized bonds, primarily asset-backed debt, accounted for about 31.6%. A cautious economic outlook and relatively high yields on investment-grade paper have kept this more conservative over the past 18 months.

The ETF doesn’t own riskier non-investment-grade bonds, but its exposure to BBB bonds rose to enhance yield. The portfolio’s 22.4% of assets in BBB rated paper increased by about 8 percentage points over the past 12 months. Bonds rated A and higher accounted for about 70% of assets and recently fell from 80% as of March 2024. The strategy also features smaller allocations to emerging-markets debt when it makes sense, but opportunities in other areas are more compelling; emerging-markets exposure has been near zero for the past five years.

Duration flexibility has paid off recently. Amid the Federal Reserve’s rate hikes in 2022, the team quickly shortened duration to 0 year from about 0.9 year; it stood at about 0.25 year as of July 2024 with the expectation of Fed rate cuts.

People High

All this team does is short-term and liquidity strategies, and it shows. It’s been nearly a decade since lead manager Jerome Schneider was named Morningstar’s Fixed Income Manager of the Year, but he doesn’t rest on his laurels. Joining Pimco in 2008, he took over leadership of the short-term desk in 2010, but this is not a one-person show. He’s joined by capable comanagers Andrew Wittkop and Nate Chiaverini, Pimco veterans who specialize in rates and derivatives, and corporate credit, respectively; they joined as comanagers in July 2021 to add depth and complement each other’s respective strengths. Schneider’s high profile at Pimco and as the longtime lead here introduces moderate key-person risk.

The team does not lack resources, human or otherwise; in 2023, it added a junior manager to the team of 13 short-term specialist managers who average nearly two decades of experience. This a stable core liquidity management team with few key departures over Schneider’s watch, and no notable exits since a senior member left in 2018. The comanagers draw on Pimco’s extensive global investment team of analysts, traders, macro experts, and risk managers, which is a comprehensive as any rival's. In addition to running dedicated short-duration mutual funds and ETFs, the team manages more than $250 billion across a range of short-term and liquidity assets for institutional accounts and other Pimco strategies.

Investor alignment is decent but can be better across Pimco’s ultrashort suite of funds. Schneider invests more than $1,000,000 and Chiaverini between $50,001 and $100,000, but Wittkop is not invested.

Eric Jacobson Director

Parent Above Average

True, Pimco could be better on pricing. Shareholders, particularly in Europe, haven't enjoyed the economies of scale that they could given Pimco's massive asset base. The firm, however, believes its pricing is fair based on what it consistently delivers for investors, and it's hard to argue that's not the case.

Pimco has generally enjoyed great success with its intense working culture, even if departures are a byproduct of that intensity and can sometimes dim the near-term outlook on strategies. Yet, more often than not, Pimco draws on its legion of skilled people and positions the next generation to thrive.

CIO Dan Ivascyn and CEO Manny Roman represent that next generation and have built on the organizational strengths they inherited. An experienced and critical-thinking investor, Ivascyn has sought to curate an elite staff and capable investment culture since he assumed his current role in 2014 and since Roman joined him in 2016. They have significantly grown the firm's pool of investment professionals and supported them by spending massively on technology and technologists to spur persistent outperformance while keeping risk in check. There may be a few others in Pimco's league, but very few.

Performance

Since Jerome Schneider’s tenure in December 2009, the strategy's 1.73% annualized return through July 2024 beat its unique ultrashort bond category median’s 1.69%, landing in the second quartile. Risk-adjusted results were slightly better than its peer median; the ETF’s Sharpe ratio, a measure of return relative to standard deviation, landed ahead of 55% of rivals.

Consistent outperformance has been a hallmark. The ETF’s more conservative approach compared to its sibling Pimco Short-Term has resulted in lower volatility over the long haul than the mutual fund, but the ETF is not immune to bumpier periods. This showed up when the portfolio's short-dated corporate stake was the main culprit behind its 2.5% drop during March 2020’s pandemic-driven selloff. And when its 1% loss trailed the typical peer’s 0.1% gain in 2022, the ETF bounced back in 2023 when the yield advantage helped its 6.2% return outpace the 5.8% gain of peers.

For the year to date through July 2024, the ETF’s 3.5% gain was better than the peer group median by 15 basis points, thanks to its yield advantage and shorter-than-average duration; the strategy’s 0.25-year duration was shorter than its typical rival’s 0.5 year as of July 2024.

Price

Based on our assessment of the fund’s People, Process, and Parent Pillars in the context of these expenses, we think this share class will be able to deliver positive alpha relative to the category benchmark index, explaining its Morningstar Medalist Rating of Gold.