March 2025 | Dan Bustamante

Bustamante & Co.

Quick Summary:

Equity market concentration the last decade into the same growth & tech names has lulled investors into both passive investing and ETF based strategies to generate returns and that is likely to change in coming years. First, we believe this era resembles 2000-2002, an era of markets where many names were richly valued and suffered from declining earnings growth which led to a death-by-one-thousand-cuts bear market. Second, we believe that there will be a need once again for diversification and active management as we move forward into the coming years.

Our view is that diversification and active management is uniquely positioned to capitalize on these coming shifts and that investors should not be complacent as they once were in recent years.

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It Works Until It Doesn't.

Last fall I wrote a piece in my weekly article about what could become a correction in the first part of 2025. In that piece I used an analogy describing investors as "**pigs being lubed up in Crisco cooking oil ready to be pushed down a slide"** as an attempt to paint the mental picture of the upcoming market correction that we just witnessed in Q1.

In short, the key points of those views then that are still shared now were:

- Mag 7 earnings growth for FY25 were set to nearly cut in half.
- The BOJ carry trade unwind and second-order effects of that.
- That passive index regime concentrated into the same names through different ETFs and other financial products which are effectively **dependent on Mag 7 growth.**

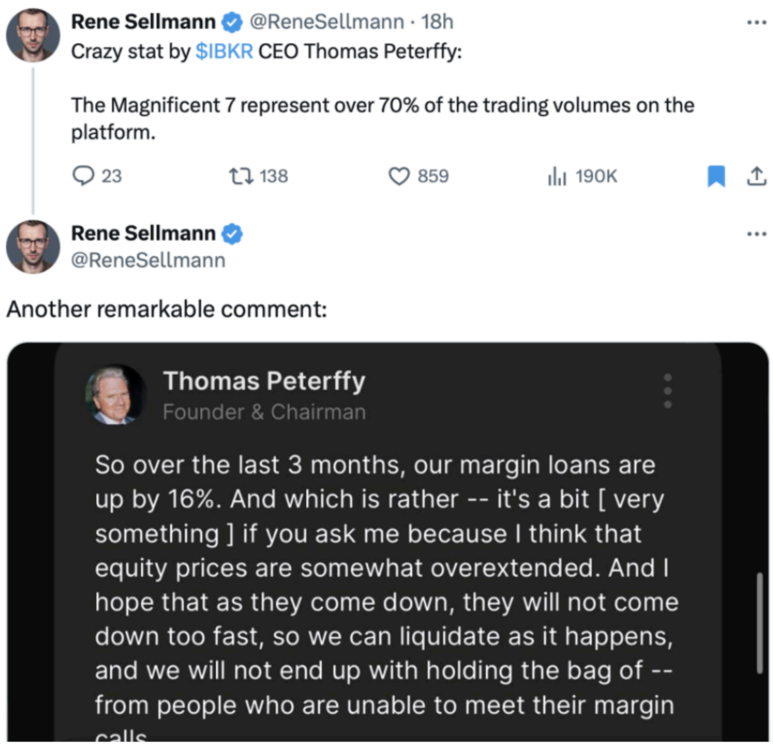
In a hyper-concentrated markets, all it took was tariffs to derail post-election gains as everyone was crowded into a handful of names that are richly valued.

- During the 2000 "dot com" bubble we had something very similar as investors chased momentum and earnings growth but even with the Fed cutting rates those companies could not return to the growth rates they were once at for many years.
- This concentration and reliance on Mag 7 earnings growth is dangerous and at a turning point.

I believe that the next bear market, whether this year or in coming years, will likely resemble the 2000-2002 bear market where it's a slow and grinding move lower leaving investors questioning what's going on instead of seeking other strategy sets.

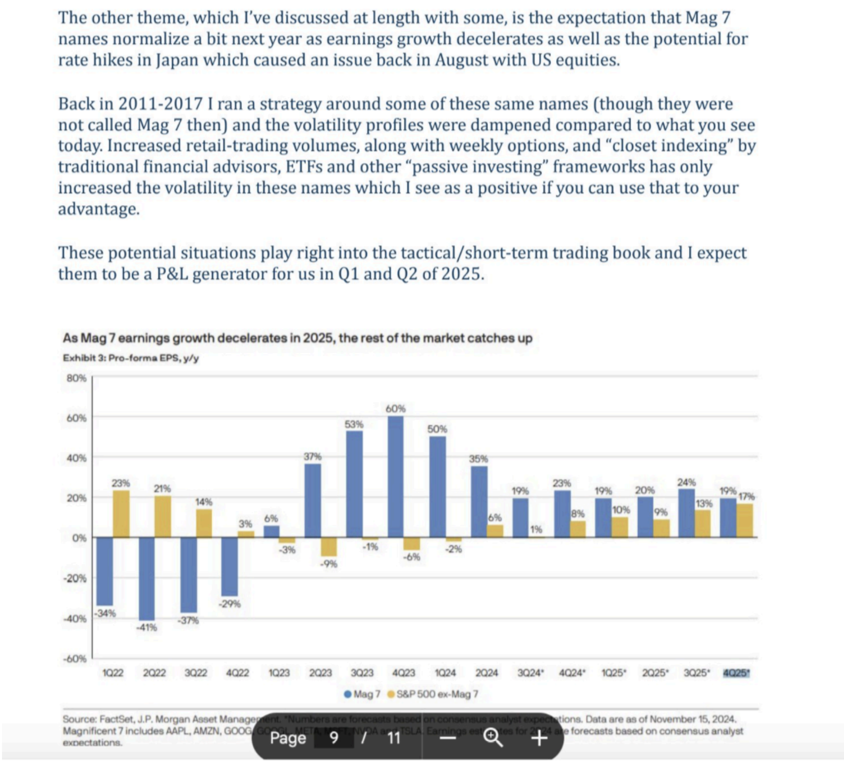
For those investors who have been lulled into complacency the last decade, **I recommend you panic, let's just do it in an orderly fashion before it's too late**.

Market concentration can be measured in various ways, this is one of many but I found it interesting and shared it as a note to others last fall. This came from Thomas Peterffy, founder of Interactive Brokers who was at a Goldman conference that made the rounds (he is not the CEO btw).



This is significant. Retail investors were not the only ones chasing these names; it was the ETFs and mutual funds as well - all dependent on their future growth - and for some - the momentum.

I warned of this as an issue in our end of 2025 letter to our investors citing the same points I am in this note to readers. **Active management will be required** and this quarter was the start of it as we used this situation of concentrated trades as a strategy-set.


The other theme, which I've discussed at length with some, is the expectation that Mag 7 names normalize a bit next year as earnings growth decelerates as well as the potential for rate hikes in Japan which caused an issue back in August with US equities.

Back in 2011-2017 I ran a strategy around some of these same names (though they were not called Mag 7 then) and the volatility profiles were dampened compared to what you see today. Increased retail-trading volumes, along with weekly options, and "closet indexing" by traditional financial advisors, ETFs and other "passive investing" frameworks has only increased the volatility in these names which I see as a positive if you can use that to your advantage.

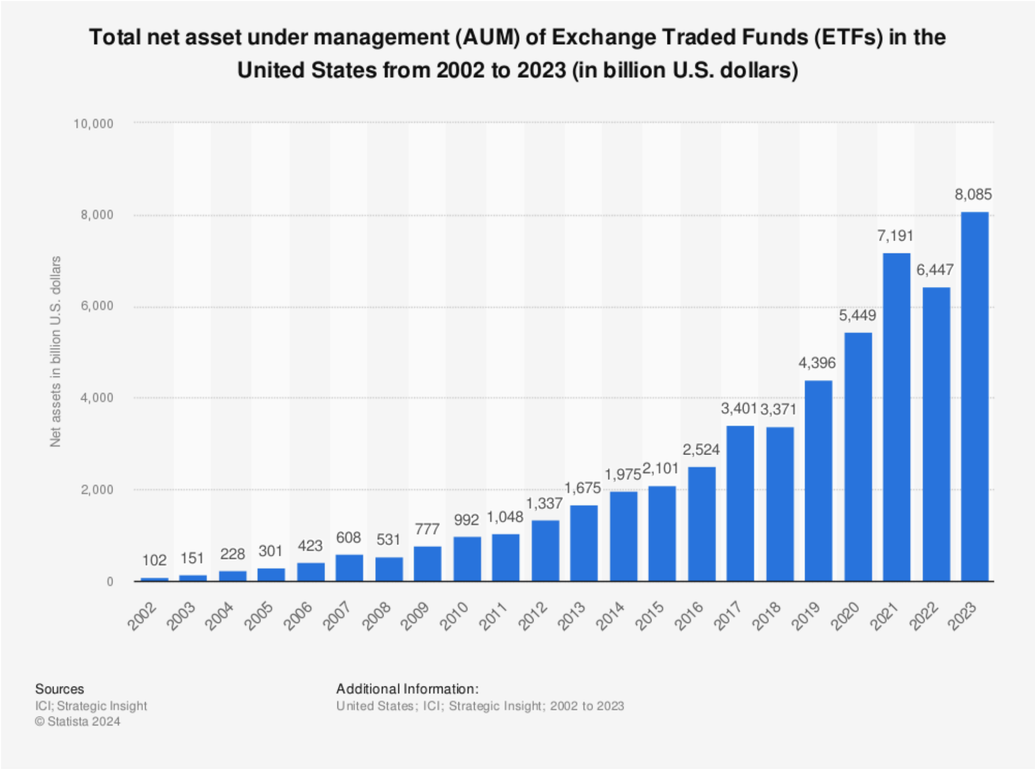
These potential situations play right into the tactical/short-term trading book and I expect them to be a P&L generator for us in Q1 and Q2 of 2025.

We held a call for year end reviews with our investors and there were two questions that were of topic and are notable: a) Why were we not invested in growth names and b) Why the high cash balances.

As a note: these questions came after the investor letter was sent out. Now maybe that's because our investors trust us or they just don't have time to read it but **this is important because as we'll cover in a few moments, the regime change is upon us.**

Those questions and the "what worked then will work again" mentality is understandable as the U.S. was the primary growth engine, driven by Mag 7 earnings and some type of stimulus in the last decade in one way or another by Central Banks and Governments. This also gave rise to the passive approach most are accustomed to as seen in the rise of ETF's (and not noted but relevant - structured notes).

- In 2002 there were only 80 ETFs in U.S. markets. In 2023 the total was 1,872 index ETFs and today that number is 3,685 - all according to Statista.
- The total net assets of the exchange traded funds (ETFs) in the United States amounted to approximately 8.09 trillion U.S. dollars in 2023. This compares to only 102 billion U.S. dollars in 2002.



This is as concentrated as it gets and we're all part of it now.

To conclude this section I want to share a note from Howard Marks of Oaktree, who I consider to be one of the best minds in the business, and who is worth reading. He posted his note "Further Thoughts on Sea Change" warning about **something very similar to what we are discussing here**.

"If this really is a sea change – meaning the investment environment has been fundamentally altered – you shouldn't assume the investment strategies that have served you best since 2009 will do so in the years ahead."- Howard Marks

This new bear market will be driven primarily by slowing growth rates and concentrated investing making this very similar to the 2000-2002 market where investors went from the "buy the dip" to a "sell the rip" mentality. For those who argue that these companies have strong balance sheets flush with cash, so were the ones in 2000-2002. But that's not what drove investors then or today: **they were after the elevated growth rates and rich multiples placed on them.**

It's Not All Bad News: There's Always Money in The Banana Stand.

For the pop-culture buffs, there was a show, Arrested Development, where George Bluth tells Michel Bluth that there is always money in the banana stand they run. When he says "There's always money in the banana stand", Michel interprets this as meaning that the Banana stand will always make money not realizing that there was $250,000 in the walls of it before they burned it down.

Watching this 45-second clip I hope illustrates the point that I am about to make:

YouTube https://www.youtube.com/watch?v=Yh3mwibfPkI

There is always money to be made if you are willing to look beyond what has worked in the past decade but if you don't listen to what is really being said, or in this case the data, then you may end up sharing the same fate as the banana stand.

For our firm that means active management and diversification - something that may be foreign to advisors and investors who may have indexed into the same names hoping for the "easy money, gravy-train" to continue.

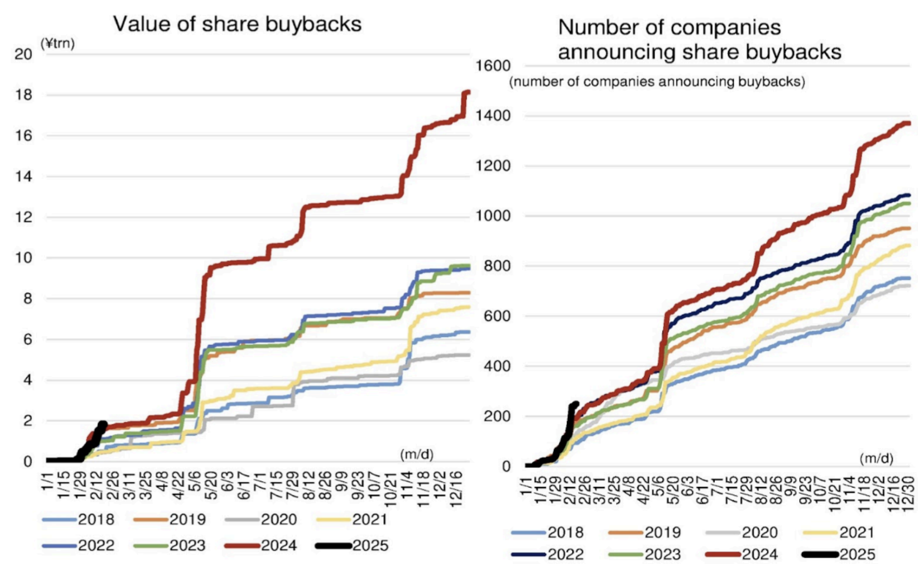
But we like doing the work here, the type of work that requires research and tact to do what most have not been doing the last decade: picking quality stocks and building diversified portfolios. Whether that means it becomes select mid-caps, Japanese equities or select turn-arounds in names that will come out of this next cycle ready to perform, there continues to be opportunity - **just not in the shiny object stocks.**

I like to think of what we do here is private equity but in public markets, meaning we can pick and choose what deals we like, don't like, how much to put in and best of all (and unlike private equity in many such cases) have the **liquidity to exit whenever we want.**

As one example, Japanese equities have our interest. In recent years they have made moves to how they treat shareholders which has included both an increase in share buybacks, which [hit a record in 2024](), as well as an overall friendlier investor environment. Warren Buffet was already well ahead of the curve on this as he began investing there in 2019 and upped his stakes nearly double as he noted in his end of year 2024 investor letter.

Fig. 7: Share buyback value and number of companies

Value up y-y in second week of February, number of companies announcing buybacks also up y-y, maintaining high levels overall



Note: Universe is all listed Japanese companies. Number of companies announcing buybacks includes duplicates (many companies announce buybacks at least twice a year). Data through 18 February 2025.
Source: Nomura, based on company data and QUICK

Things always work until they don't and usually investors don't realize it's shifted until it's already too late. In this instance, we believe that the regime shift is here and that a move back to active management and diversification will be one, of many, strategies investors will begin to pursue once again. `

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