Hosking Partners®

# Quarterly Commentary Q4 2024

Hosking Partners is authorised and regulated by the Financial Conduct Authority and is registered with the Securities and Exchange Commission as an Investment Adviser. Hosking Partners LLP (ARBN 613 188 471) is a limited liability partnership formed in the United Kingdom and the liability of its members is limited. Hosking Partners is an authorised financial services provider with the Financial Sector Conduct Authority of South Africa in terms of the Financial Advisory and Intermediary Services Act, 37 of 2002. FSP no. 45612.

**www.hoskingpartners.com | info@hoskingpartners.com | +44 (0) 20 7004 7850 | 11 Charles II Street, London, SW1Y 4QU**

**24 January 2025**

Alice: “One can’t believe impossible things.”

Red Queen: “I dare say you haven’t had much practice.”

*Through the Looking Glass and What Alice Found There*, Lewis Carroll, 1871

The year just ended represents another period in which Hosking Partners reports positive absolute returns but relative Fund underperformance, and we reflect below on the causes and consequences of this alongside our review of recent capital market trends. It is no accident that we begin the 2024 year-end report with the same quote from Alice with which we ended the 2023 letter. Last year saw an extension of many of the seemingly impossible market forces from the year (decade?) prior, but we believe that recent shifts in the geopolitical environment may just push markets to an inflection point.

On the face of it, global equities enjoyed good conditions, rising 17.5% for the year despite a 1.0% decline for the most recent quarter. In contrast the strategy appreciated only 12.2% (net) for the year, after a 2.7% decline for the quarter. This performance, a relative net underperformance of c. 5.3% for the calendar year is somewhat redeemed given that it is measured in USD and during a period of declining inflation, which means that the purchasing power of our clients’ funds has increased respectably. However, as we all know, active fund managers are also in a performance race against competitors and the stock market indices. Both can represent formidable challenge, the latter especially so.

For 2024 as a whole, the c. 5.3% underperformance reflects the dominance of the US stock market, to which the strategy remains materially underweight (at 40% of strategy assets vs. the c. 67% weight in the MSCI All Country World Index), and at the stock picking level the dominance of a handful of market leaders, known colloquially as the “Magnificent Seven.” Together these shares represent c.

33% of the S&P index by value and, by extension, they now represent some 22% of MSCI ACWI. It is worth remembering that ACWI is the strategy's benchmark for performance reporting purposes, but the strategy's bottom-up portfolio management remains benchmark agnostic. We will comment on this extraordinary and time-specific phenomenon further below. However, first we must cover off the more prosaic detail of the recent quarter. Note the limited relevance of one quarter's numbers in the context of the strategy's long-term focus, reflected in a holding period of 3.5 years and turnover of 7.1%. Turnover measures in 2024 were boosted by the recent tactical asset allocation rebalancing between the strategy's four multi-counsellors.

From an allocation perspective, the strategy's underweight to the US market hurt relative returns in the most recent quarter and for the year as a whole. This trend was further boosted by the market's enthusiastic response to the election of the new US President and the associated Republican "clean sweep" of Congress. It is widely acknowledged that the US stock market is fully valued, if not actually over-valued, especially on a cyclically adjusted valuation basis. Underpinning this is a longstanding improvement in corporate profitability which is believed to be durable. By contrast, the strategy is overweight those markets that remain broadly out of favour. Despite increasing levels of investor activism in Japan, the strategy's overweight to that market detracted from the quarterly relative returns, as did the overweight to the UK - that theme park of old economy firms, several of which now seek exile in the more receptive environment of Wall Street. As usual, emerging markets underperformed relative to the US. The challenges that the emerging market asset class faces have become acute with the preference for indexation and, amongst active managers, the demand for "high conviction" (ha ha) concentrated portfolios. It is easy to understand why a regional asset class that has traditionally described and sold its attractions as based on superior rates of macro-economic growth should have difficulty in the current era of high stock-picking focus, asset light capital structures, as well as the aforesaid preference for concentrated portfolios.

For the quarter just ended, the performance attribution allow us to dig deeper into the components of the overall 171 basis point underperformance. Nearly all this was related to the US positioning, mainly the geographical underweight (including under exposure to the US dollar). Stock picking was also a negative contributor, but happily a very minor one. This reflects an apparent broadening of the US equity market in the period, which itself must represent investor optimism regarding pro-growth inclinations of the new administration.

The strategy's exposure to Europe saw a quarter of contrasts. The strategy did well on the continent, by virtue of its underweight allocation to the region and positive stock picking. The Achilles heel was the UK and the strategy's significant four-fold overweight versus benchmark. Most commentators acknowledge the UK's undervaluation, but with Kier Starmer's new Labour administration lurching from difficulty to difficulty, a return of bullish investor "animal spirits" seems way off. Things may have to get worse before they get better. Our long-term investment horizon and bottom-up, supply-focused approach allow us to see through the short-term market noise to invest in the corporate babies that are being thrown out with the bath water. Meanwhile, the strategy's other material regional overweight in Japan (built up over the last two years) was held back in relative performance terms by renewed weakness of the yen. The strategy's emerging market overweight (at 14% vs c. 10% for the benchmark) added value in stock picking, with the star role being played by the turnaround in Sri Lanka, where recent Presidential and Parliamentary elections have reinforced the likelihood of a strong economic recovery and more orthodox national finances.

Many of the quarterly performance remarks apply also to the calendar year attribution analysis. Over this longer timeframe the US positioning accounted for the vast majority of the annual underperformance, and half of that came from stock picking, notably from within the value and cyclical bias. Again, the strategy's underweight to continental Europe was an asset allocation positive, while the UK was a asset allocation negative. Emerging markets had no material impact in either direction for the year, although attention should be drawn to significant adverse currency

moves in South Africa and Mexico. In Japan, the weakness in the yen overwhelmed allocation and stock picking gains. Finally in developed Asia ex-Japan, the strategy's investments in Hong Kong struggled, notwithstanding increasing efforts by the PRC Government to reflate the Chinese economy.

The attribution analysis also details the high and low points of our stock picking. Although the year and the quarter will be remembered for the relative performance of the Magnificent Seven, there were silver linings among the gloom for value investors. Bank shares for example benefited substantially from the "Trump Bump," presumably reflecting the pro-growth and lower tax inclinations of America's new President. Indeed, recent expectation changes that rates will remain "higher for longer" may presage a more favourable outlook for value sectors over the next 12 months, as elevated discount rates nibble away at discounted cash flow valuations. It is important to reflect on the various stages and aftermath of the Covid-era and how that has impacted capital market trends. In Phase 1, interest rates fell to zero as nations were locked down and digital adoption accelerated. Then came the inflation pick-up and the behind-the-curve interest rate increases. In both phases most value sectors underperformed; in Phase 1 because the net present value of growth streams became inflated, and in Phase 2 because investors (wrongly) anticipated a recession. Now that the odds favour a soft landing, the environment for a broader stock market environment is much improved.

Stock market historians of the future will chronicle the resurrection of Apple Inc from an enterprise value of close to zero in 2005 to one of $3.8 trillion today, but it is likely that (in a reprise of life-imitating-art) it will be the iPhone which is designated as the "motor that moved the world", a Randian metaphor worthy of *Atlas Shrugged*. It would be surprising, given the way that digitisation has altered all our lifestyles, if the stock market had not taken valuations in this momentum era to excess. A contributory but 'inverse' factor would be the comparative slow progress that old economy firms have made to improvement of their return on assets (RoA), which is a failure the fund management

industry must take a degree of responsibility for, with its indulgent attitude to old economy firm capital expenditures. This has made the free cash flow returns on assets of the Magnificent Seven even more relatively remarkable.

Another contributory factor to the narrowness of stock market returns is the popularity of indexation. As active managers are underweight Magnificent Seven stocks (for whatever reason), then any asset allocation decision toward indexation produces a net-buyer effect for the techno-leaders. In 2024 alone it is estimated that US$450bn was redeemed from active funds in favour of index-like alternatives. However, past is not necessarily prologue. The digital firms are becoming far more capital intensive as they embrace AI and plough shareholders' funds into data-centre construction amongst other projects. Thus, the RoA differential between growth stocks and value stocks should narrow in the years ahead, and converging valuation relativities should exacerbate that compression.

Intriguingly it may be the election of Donald Trump that ushers in the reversal of what we may call the "Alice in Wonderland era," a period in which people embraced, to an extraordinary extent, fantastic concepts and seemingly impossible geopolitical realities and economic predictions for the future on an industrial scale. In fairness none of us possessed an effective immunity from this. During the period, pundits embraced an inefficient energy system as a harbinger of economic growth and fantasised about monetary recklessness (such as zero interest rates) being divorced entirely from consequential inflation and wealth disparity growth. In response, investors indiscriminately exited the established "brown" energy and materials stocks that are now increasingly recognised as a necessary reality to enable a "green" shift, the time frame for which has been indefinitely extended. For contrarian capital cycle investors, this created a compelling investment opportunity.

Alas it appears clear that the skies are dark with chickens coming home to roost, both in America and in Europe. It is possible that the same technologies which have revolutionised lifestyles to great benefit were also used to speed up the course of social discourse and to bypass society's critical

and reflective evaluation of social change, via so called “permission structures.” Extreme views have always been found at both ends of the political spectrum. In this period however, it can be argued that some of the most extreme views of all were actually held by moderate elites, and associated role-models, in what should henceforth be described as the “Far Centre”.

Should the Alice in Wonderland views of the Far Centre come to be reined in, let alone reversed, it is likely there would be mirror effects in the financial markets. These could even include a bear market and relative strength exhibited by hitherto out of favour sectors. This is not to say that political extremes and the momentum bull market are directly causative of one another. The observation here is that both trends are so deeply embedded, that it would be strange if a change in direction of either one did not lead to a change in both. Such an outcome would, at the least, be unsurprising.

There are encouraging exceptions to the above pessimism, however, such as the embrace of shareholder value in Japan, which will lead to a surge in profitability and an even greater rise in share values. The relative performance difficulties of the past year, and indeed recent years, indicates that a very strong case can now be made for a stock market rotation in favour of value sectors in which the strategy’s investments are concentrated. For example, the strategy’s investments in the Magnificent Seven aggregate to 3.7% of the strategy, versus an aforesaid 22% for the ACWI index. It seems likely, if not highly probable, that actions of the new government in the USA will reinforce the broadening of the US stock market that is already apparent. It remains to be seen exactly how the paradoxical blend of tax cuts and tariff increases will combine, but it is also likely that the cocktail of populist policies will play out to the benefit of the strategy with its in-place deeply value-oriented stance. It is a stance which has been gradually increased in the past several years, and which is now poised to pay off.

**Weights based on a representative account and benchmarks weights as at 31 Dec 2024.*