JANUARY 2025

The Download

Farewell to the Mag 7 era?

FRONTIER
ASSET MANAGEMENT

The times they are a-changin’?

In 2024, it wouldn’t have matter much if an investor was marginally underweight equity, it mostly just mattered how much Magnificent 7 exposure an investor owned.

Fast forward to 2025, and the expected returns of most equity asset classes, excluding U.S. large-cap stocks, offer investors promising growth potential and substantial opportunities to diversify their portfolios beyond the realm of the Magnificent 7.

To seek to take advantage of these opportunities, at Frontier, we’re marginally increasing our exposure to specific equity classes in many of our strategies. I invite you to continue reading to gain insights into the market themes shaping our strategic decisions.

- Geremy van Arkel, CFA | Director of Strategies

Come writers and critics
Who prophesize with your pen
And keep your eyes wide
The chance won't come again
And don't speak too soon
For the wheel's still in spin
And there's no tellin' who
That it's namin'
For the loser now
Will be later to win
For the times they are a-changin’

- Bob Dylan

…Or not…

The single driver of return

Over the past year (and 10 years), there has basically only been one way to perform well: to hold more U.S. large-cap growth stocks.

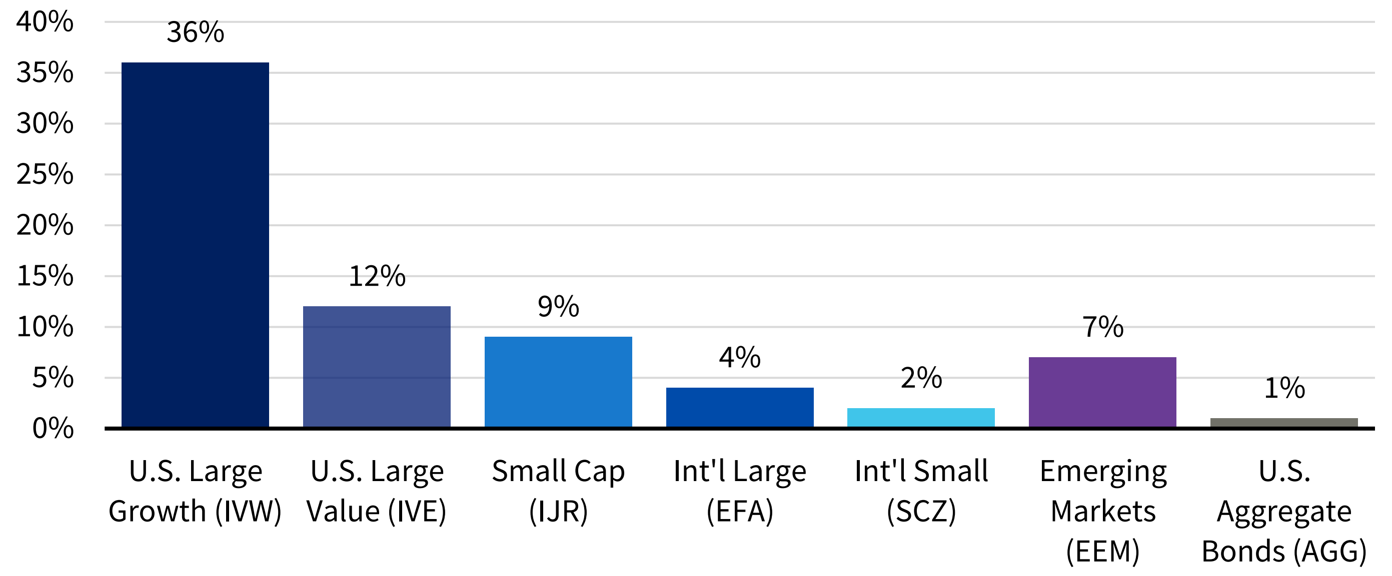
The outperformance of U.S. large-cap growth stocks has been so dramatic that they have effectively been the main driver of portfolio returns – if not the only driver.

If a manager owned more large-cap growth in the U.S., they performed well; if they owned less, they appeared to have underperformed. It hardly mattered if you were marginally overweight or underweight to general equities; it only mattered how much U.S. large-cap growth you had.

47% of the S&P 500 Growth index is invested in the Magnificent 7 stocks.

That’s it, there is not much else to say here.

1-YEAR RETURNS FOR MAJOR ASSET CLASSES ENDING DECEMBER 31, 2024



Source: Morningstar. **Past performance is no guarantee of future returns.**

Markets in a state of imbalance

There are no surprises here. I have become a broken record on the topic of market concentration. For the last 10 years, the S&P 500 Index, and specifically U.S. large-cap growth stocks, has dominated the returns of every other major asset class.

Investors are unequivocally attracted to past performance in the belief that it will continue – and, so far, it has. This unrelenting outperformance from U.S. large-cap stocks has led to investors abandon actively managed strategies for approaches that simply hold more large-cap growth stocks like the S&P 500 Index (which inordinately holds large growth stocks), and more specifically, the Magnificent 7 stocks.

Buyers have flocked to a narrower and narrower corner of the world's investable markets, which in turn has led to near historically high valuations of U.S. large-cap stocks, while other equity asset classes are left materially undervalued. But, apparently, even owning the S&P 500 Index is not enough for many investors. For these investors, owning the seven largest stocks in the S&P 500 index is the only way to go. These seven stocks, known as the Magnificent 7, are the real driver of the S&P 500 Index's performance.

Source: Goldman Sachs, @ISABELNET_SA thru Lance Roberts on X

Market cap of largest 7 companies in S&P 500
Percent of total index market cap

Source: FactSet, JPMAM, November 30, 2024

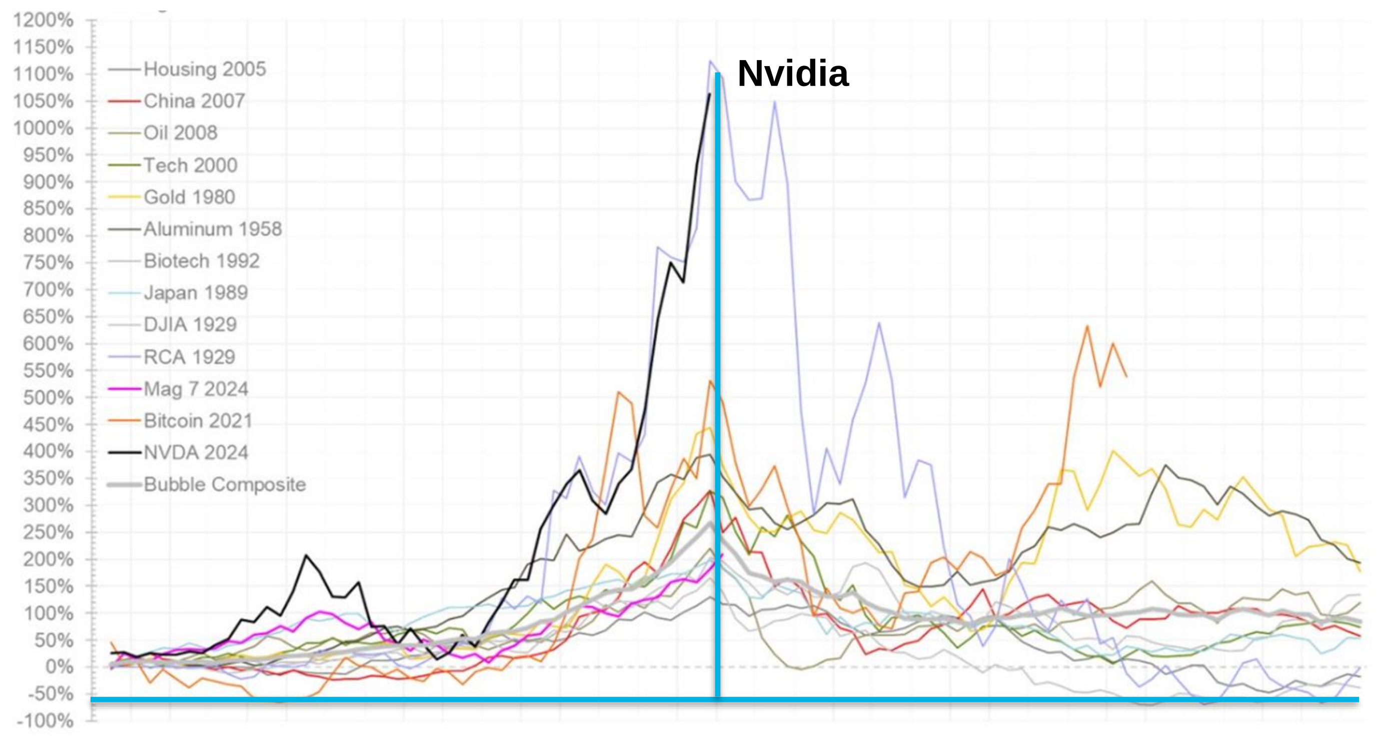
Source: Magnificent 7 = Alphabet (GOOGLE: GOOG), Amazon (AMZN), Apple (AAPL), Meta Platforms (META), Microsoft (MSFT), NVIDIA (NVDA), and Tesla (TSLA). **Past performance is no guarantee of future returns.**

Booms and busts are a constant...

Is the Magnificent 7 phenomenon a bubble?

I guess we will just have to wait and see.

A HISTORY OF BOOMS...AND BUSTS



Data source: FMRCo, Bloomberg, Haver Analytics, Factset, Data as of 6/30/2024. **Past performance is no guarantee of future returns.**

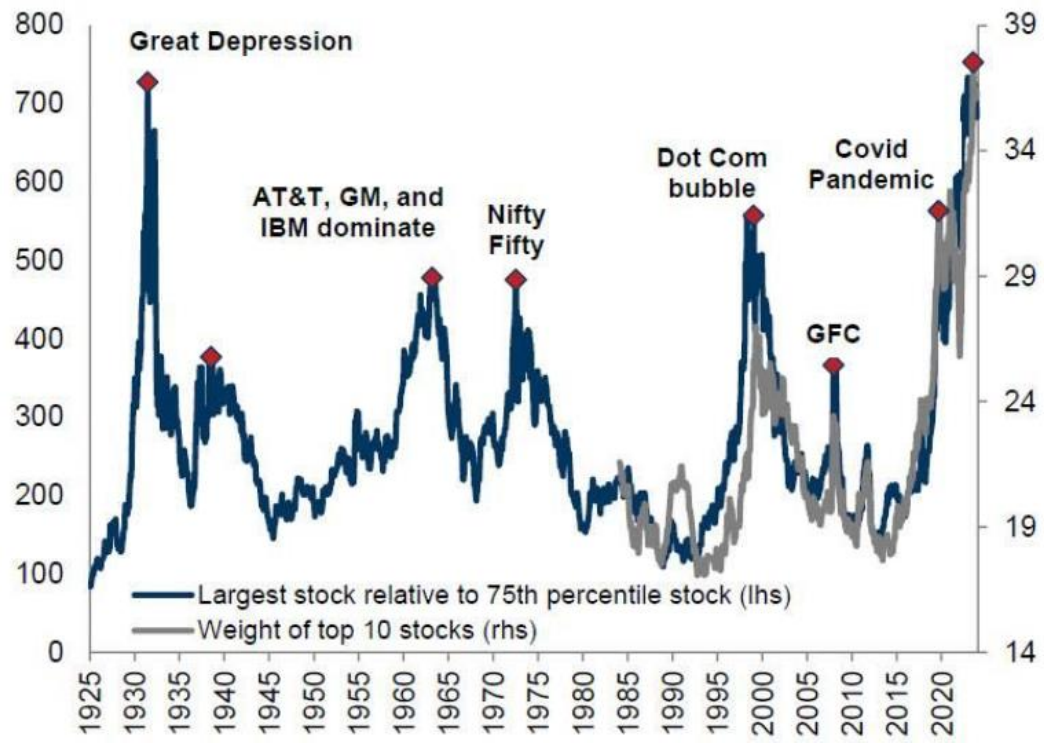
History tells us...

This type of market concentration has signified the worst times in history to invest.

This euphoria of owning a specific thematic corner of the market has occurred several times in the past: 1929, 1965, 1973, and 1999, and all these periods represented the beginnings of the worst decades on record for the S&P 500 Index.

Secondly, these points also represented some of the best times to redeploy capital away from the S&P 500 Index, as leadership changes happened quickly and unexpectedly, and the return opportunities could be dramatic.

HISTORIC POINTS IN TIME OF EXTREME MARKET CONCENTRATION:
A near perfect hit rate of predicting the worst times to invest in the S&P 500

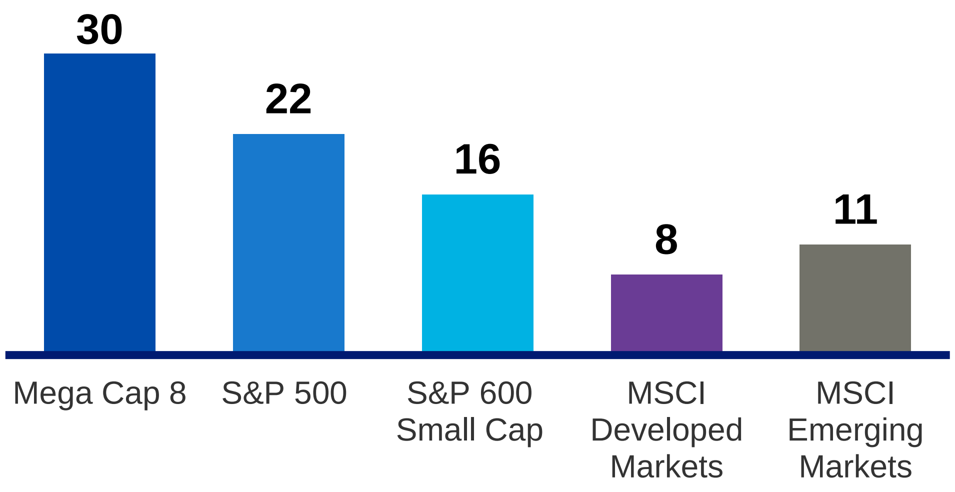


Consists of U.S. stocks with prices, shares, and revenue data listed on the NYSE, AMEX, or NASDAQ. Series prior to 1985 estimated based on data from Kenneth French data library reflecting the market cap distribution of NYSE stocks. Source: Compustat, CRSP, Kenneth R. French, Goldman Sachs GIR. **Past performance is no guarantee of future returns.**

While investors are as bullish as ever…

U.S. large- cap stock valuations are near historic extremes – thus representing low expected returns. Sooner or later, valuations matter.

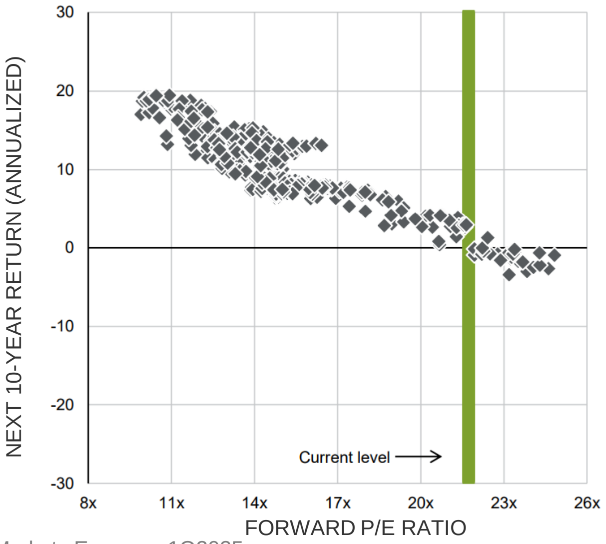
SELECT FORWARD P/E RATIOS



Source: Yardeni, Mega Cap 8 = Magnificent 7 + Netflix

The starting P/E has been a reasonable indicator of long-term future returns. When starting P/Es where high, 10-year future returns were low, and vice versa.

S&P 500 FORWARD P/E RATIOS & SUBSEQUENT 10-YEAR RETURNS - % ANNUALIXED TOTAL RETURN



JPM Guide to Markets Europe – 1Q2025

Fed cuts?

Consequently, in the fourth quarter, expectations on the trajectory of Fed rate cuts were significantly curtailed. The Fed now appears closer to the end of their rate cut cycle, as opposed to near the beginning. Is this a dent to the narrative of a bull market with no consequences?

December 27, 2023:
The “Market” believed the Fed would lower Fed Funds Rate rapidly and stop at 3.5%.

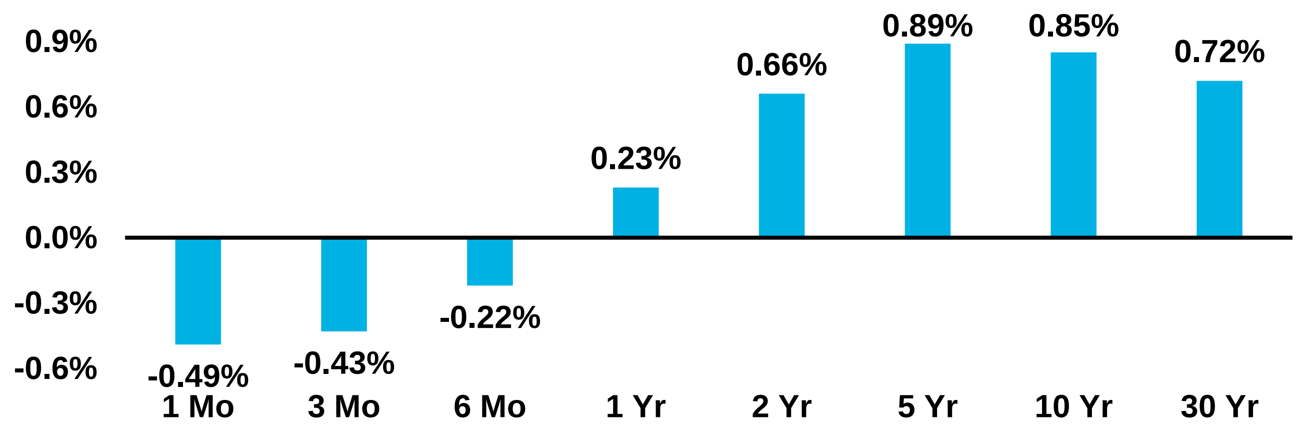
December 26, 2024:
The “Market” changes its view on less dramatic rate cuts and with an estimated ending rate of 4.0% which is 50 basis points (bps) higher than conventional wisdom just a year prior.

THE “MARKET” IS NOW EXPECTING LESS RATE CUTS AND A HIGHER BASE FED FUNDS RATE

Interest rates and inflation: Higher for longer?

Confusingly for the “extending duration" crowd, longer dated interest rates actually rose last quarter.

CHANGES IN INTEREST RATES
Post Fed Rate Cuts: (Sept. 19th-Dec. 31, 2024)



Why did longer dated interest rates rise when the Fed was cutting interest rates?

If the economy is strong (mainly due to high asset prices), when the Fed cuts rates alongside China and Europe, the world’s central banks are providing stimulus into an already strong economy. Savvy bond traders would see this as inflationary.

If the Fed continues to cut rates, some market participants will view this as increasing the chance of higher inflation and higher long-term interest rates.

Since 2022, the evidence suggests that we have been operating in a “higher for longer” environment when it comes to interest rates and inflation. Last quarter’s rise in interest rates was further confirmation of this point.

Source: Treasury.gov. Data as of December 31, 2024. **Past performance is no guarantee of future returns.**

What should interest rates be?

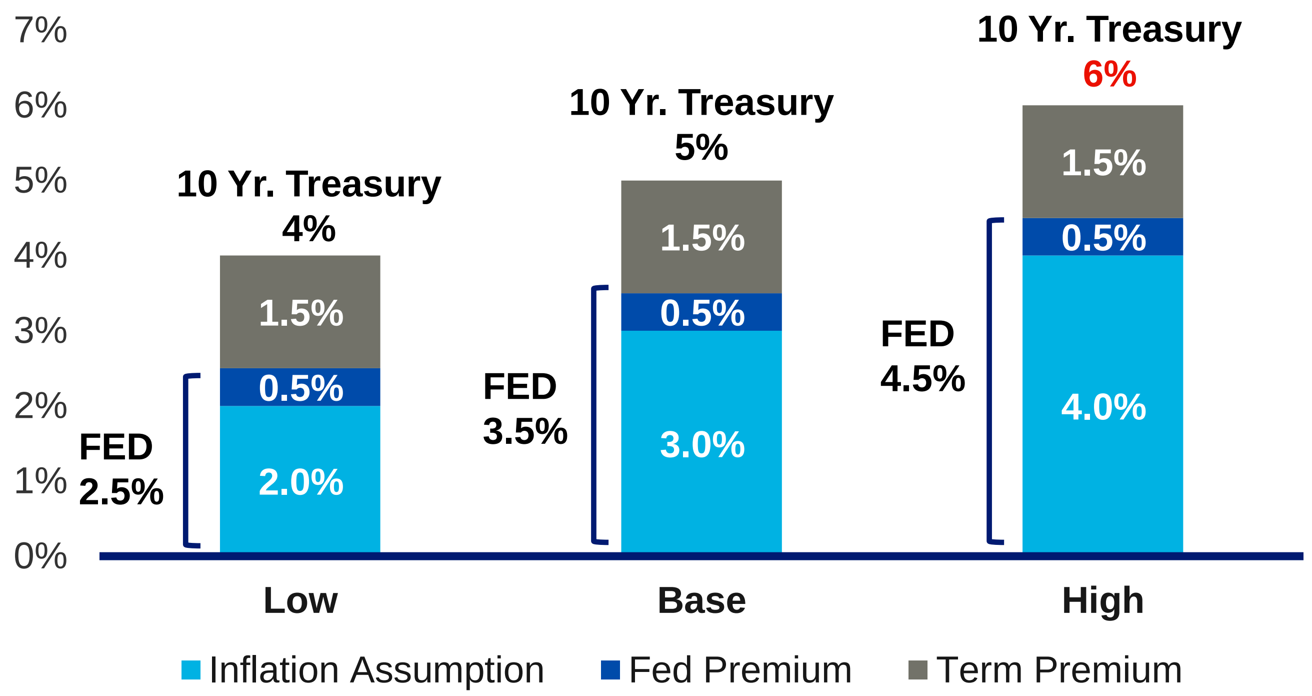
Today, the Fed Funds Rate is 4.25 to 4.5%, and the 10-year treasury yield is about 4.7%.

If the base case inflation estimate is 3%, then in 2025, it would be logical (based on history) to expect that the Fed might cut short-term rates a couple of times to get closer to 3.5% and for the 10-year treasury yield to rise closer to 5%.

However, if the base inflation estimate is closer to 4.0%, then the Fed will likely pause, but the 10-year treasury could rise to closer to 6%.

If equity or real estate prices fall though, all bets on interest rates are off. The Fed will likely cut rates to save asset prices, and investors will likely flock to treasuries for safety (which lowers interest rates in the marketplace).

10-YEAR U.S. TREASURY YIELD SCENARIOS



Source: Frontier Asset Management.

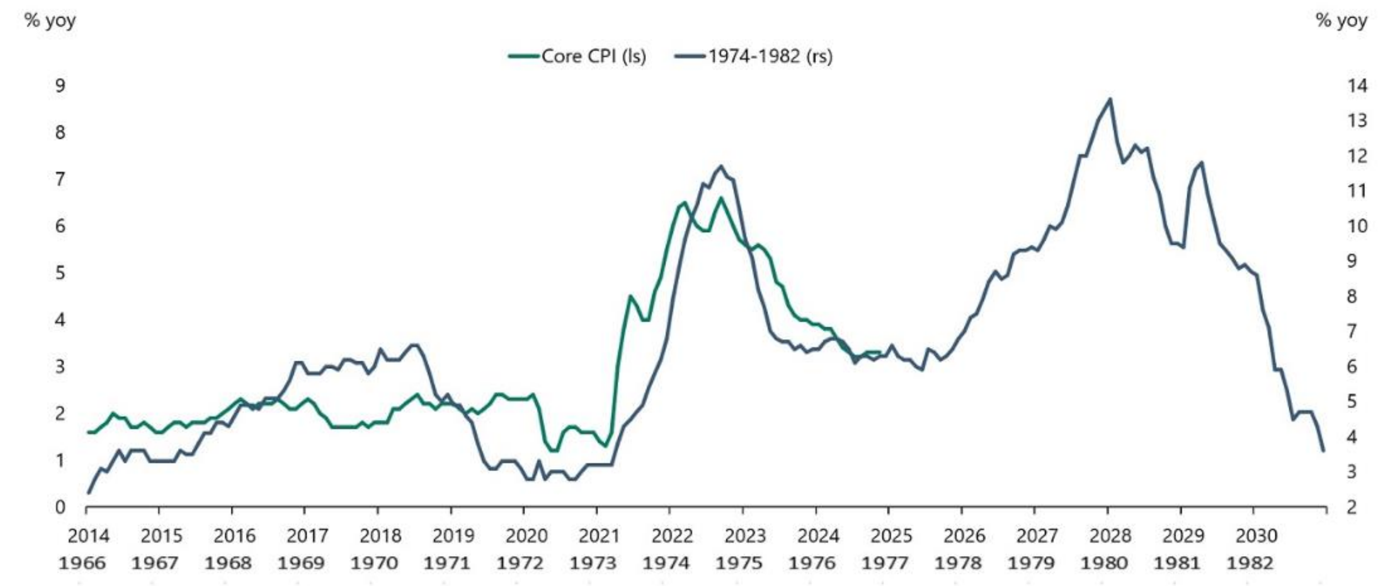
So, what's the risk?

For many investors, it is a foregone conclusion that the Fed is in a virtuous easing cycle.

An alternate path to consider is that of the 1970s. During that era, inflation was persistent, policies were inflationary, and the Fed had to reverse course and raise rates.

This type of scenario could present a significant risk for most asset classes and is a risk that is probably not currently factored into asset price expectations. While it's not probable that we follow the 1970s interest rate pattern, it is possible.

1966 – 1982 INFLATION RATE PATTERN VS. 2014
Current Era Inflation (Green)



Source: https://www.apolloacademy.com/inflation-rising-again/

Since 2022, most asset classes have trailed T-Bills

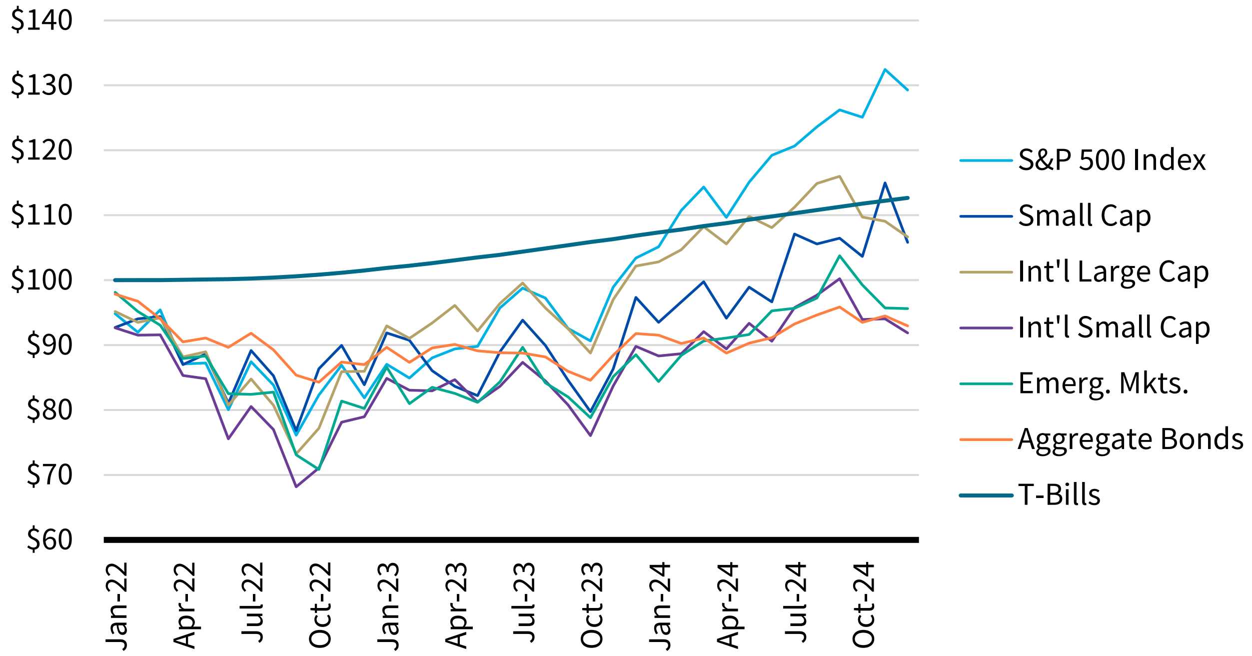
It could be said, that 2022 marketed the beginning of the "higher for longer" era.

Asset prices – in theory – should be negatively impacted by higher interest rates and higher inflation, and most have been.

Clearly, U.S. large cap stocks, as represented by the S&P 500 Index, have been the only winners in this environment (driven of course by the Magnificent 7).

But how should we think about those other underperforming asset classes now?

MOST ASSET CLASS RETURNS BELOW T-BILLS
Since the beginning of the "Higher for Longer" Era



Source: Morningstar. Small Caps = S&P 600 Index, Int'l Large Cap = MSCI EAFE Index, Int'l Small Cap = MSCI EAFE Small Cap Index, Emerging Markets = MSCI EM Index, Aggregate Bonds = Bloomberg U.S. Aggregate Bond Index, T-Bills = FTSE 90-Day T-Bills

Buy low, sell high

Skating to where the puck is going to be

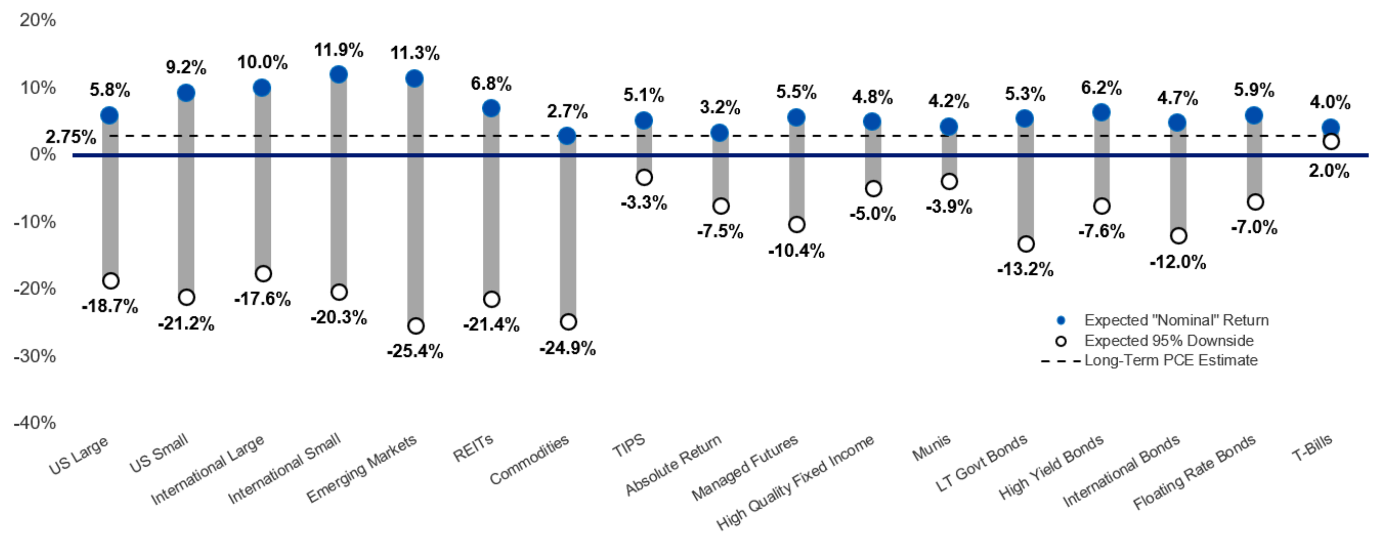
Past performance is not indicative of future returns, and in many cases, it is quite the opposite. Often, it is those investments that are being indiscriminately sold today that will likely become tomorrow's winners.

A material driver of the dollars flowing into the S&P 500 Index and the Magnificent 7 are coming from other investments being indiscriminately sold. Understanding this, you can quickly see what an opportunity this creates.

From this point forward, small stocks and international stocks are expected to outperform the S&P 500 Index by a wide margin (in some cases nearly double the expected return). These high expected returns are almost too good to pass up. Rarely are we offered this sort of opportunity.

FRONTIER'S ASSET CLASS EXPECTED RETURNS: JANUARY 1, 2025

Rarely do we see differences in expected returns of this magnitude



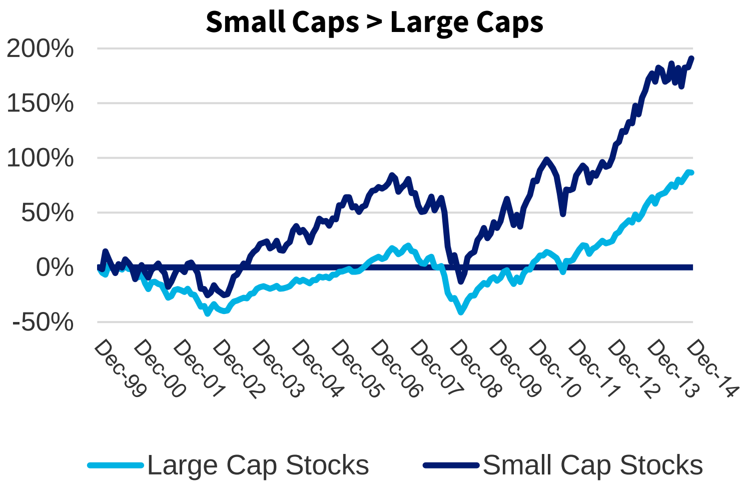
All figures as of December 31, 2024, unless otherwise stated. Source: Frontier Asset Management

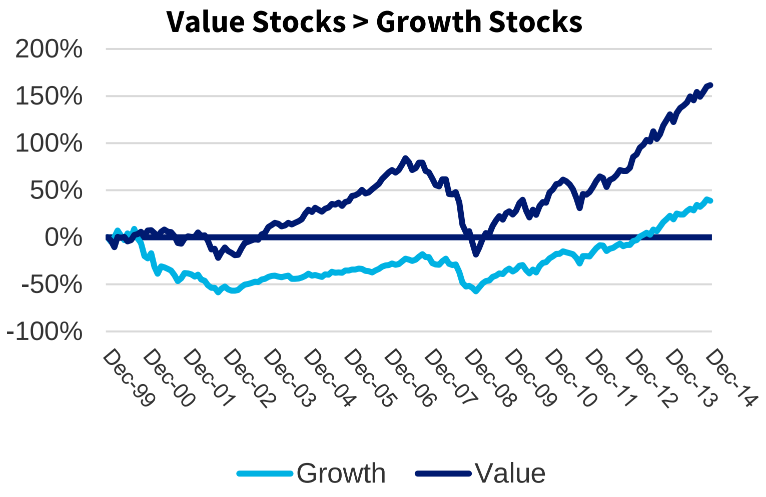
For illustrative purposes only. Expected Returns are hypothetical in nature and are not a guarantee of future performance. Any estimate or similar predications of returns are based on assumptions and assessments made by Frontier that it considers reasonable under the circumstances. Frontier Asset Management calculates capital market assumptions at least monthly and sometimes more frequently if markets are exhibiting significant volatility. All data is represented on an annualized basis. Each asset class is associated with a unique expected time horizon, determined by the investment's duration. Volatility and correlations are forecasted for a period of one year that includes inflation. While Frontier believes that these assumptions are reasonable, there can be no assurance that the results will be obtained.
*Full 20-year expected return data is not available.

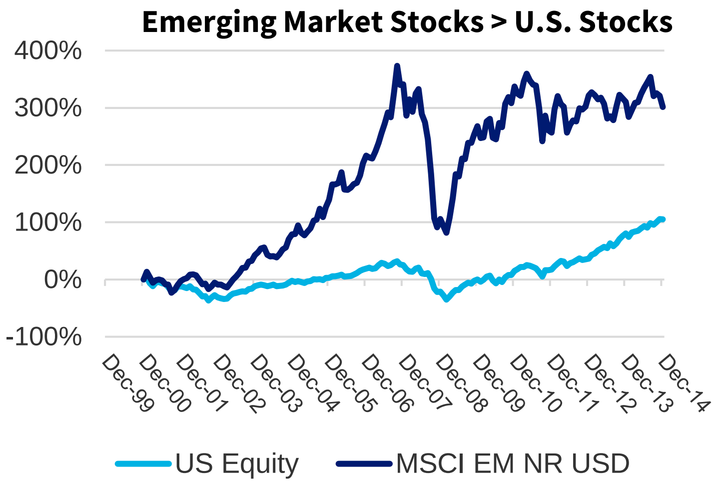
For the loser now will be later to win.

Opportunities to buy low don't come along very often. The last time I saw such an opportunity was in the late 1990s, when value stocks, small stocks, international stocks, and basically everything else was kicked to the curb to buy internet stocks. When the return to "normal" came, it created opportunities of magnitude.

SELECTED ASSET CLASSES POST 2000, 15 YEARS OF NEW WINNERS, AND BY A LARGE MARGIN







Frontier Asset Management, Data as of September 30, 2024. Sources: Morningstar, Bloomberg. U.S. Equity = S&P 500 Index / EM Equity = MSCI Emerging Markets USD Index.

Run with the herd or step away?

That's a question for you.

Frontier has chosen to follow logic, foundational investment principles, and our decades of experience to definitively step away from a herd that is furiously rushing to own U.S. large cap indexes.

On the asset class front, the foundation of buy low, sell high – which is driven by expected return differentials – is the principle behind our asset class positioning.

On the implementation front, we are emphasizing those experienced mutual fund managers who are unafraid to venture into securities that fundamentally offer strong prospects, regardless of the latest fads. Their opportunity set for security selection is ripe for outperformance, as many of these opportunities are occurring due to the selling of almost everything to buy effectively just seven stocks.

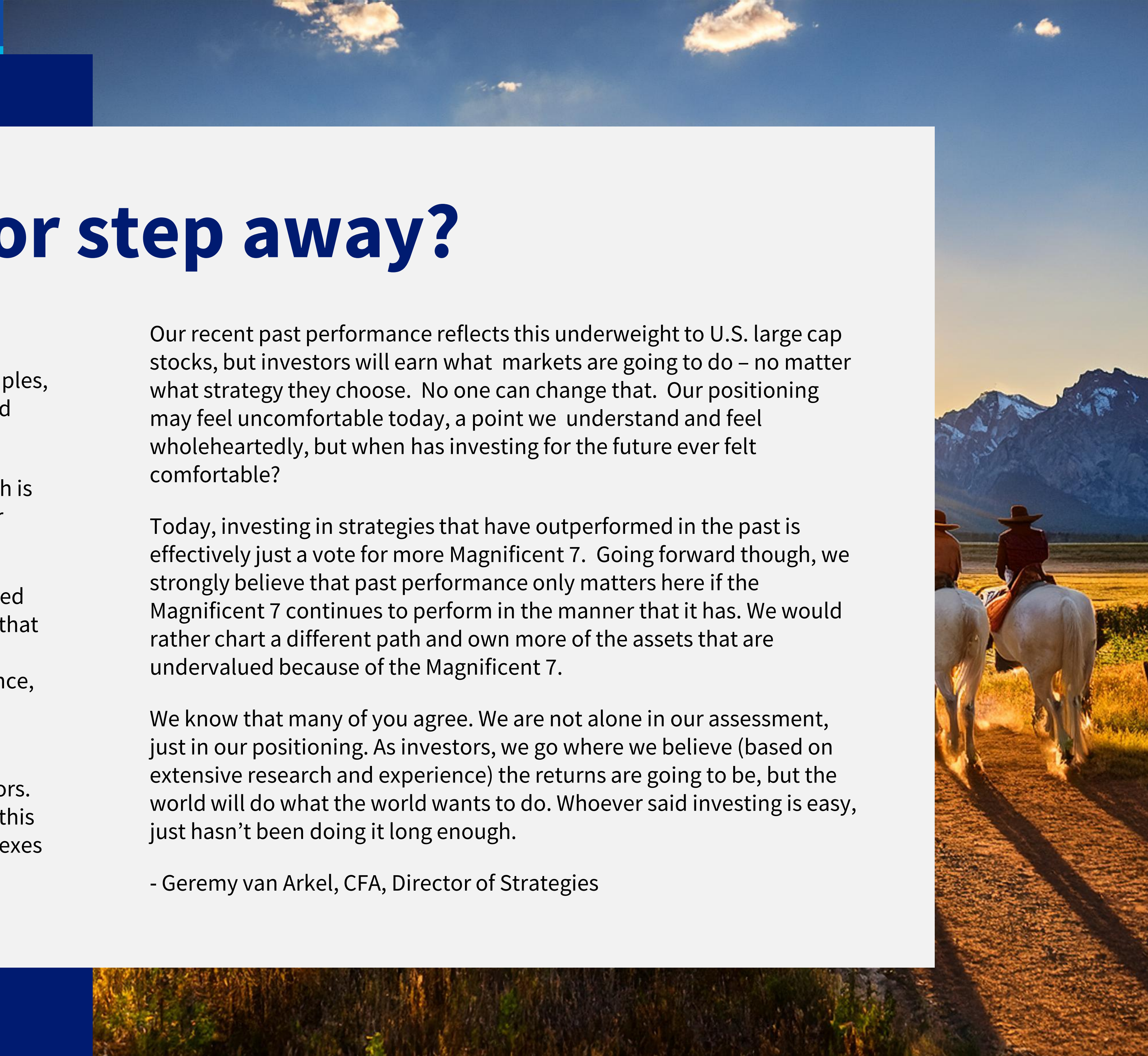
We believe Frontier's positioning offers compelling value to investors. As far as we know, we are one of the few lone firms that have used this opportunity to allocate our strategies away from U.S. large cap indexes and the Magnificent 7.

Our recent past performance reflects this underweight to U.S. large cap stocks, but investors will earn what markets are going to do – no matter what strategy they choose. No one can change that. Our positioning may feel uncomfortable today, a point we understand and feel wholeheartedly, but when has investing for the future ever felt comfortable?

Today, investing in strategies that have outperformed in the past is effectively just a vote for more Magnificent 7. Going forward though, we strongly believe that past performance only matters here if the Magnificent 7 continues to perform in the manner that it has. We would rather chart a different path and own more of the assets that are undervalued because of the Magnificent 7.

We know that many of you agree. We are not alone in our assessment, just in our positioning. As investors, we go where we believe (based on extensive research and experience) the returns are going to be, but the world will do what the world wants to do. Whoever said investing is easy, just hasn't been doing it long enough.

- Geremy van Arkel, CFA, Director of Strategies



Important Disclosure Information

Past performance is no guarantee of future returns. Nothing presented herein is or is intended to constitute investment advice or recommendations to buy or sell any type of securities, to invest in any particular asset class or strategy or as a promise of future performance, and no investment decision should be made based solely on the information provided herein. There is a risk of loss from an investment in securities, including the risk of loss of principal. Different types of investments involve varying degrees of risk, and there can be no assurance that any specific investment will be profitable or suitable for an investor's financial situation or risk tolerance. Diversification and asset allocation do not ensure a profit or protect against a loss. All performance results should be considered in light of the market and economic conditions that prevailed at the time those results were generated. Before investing, consider investment objectives, risks, fees, and expenses. Frontier may modify its process, opinions, and assumptions at any time without notice as data is analyzed.

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GLOSSARY OF INDICES:

- **Large Cap US:** S&P 500 Annual Total Return Index = The investment return received each year, including dividends, when holding the S&P 500 index.
- **Small Cap US:** S&P SmallCap 600 Index = Stock market index established by S&P Global Ratings. It covers roughly the small-cap range of American stocks, using a capitalization-weighted index.
- **Large Cap International:** MSCI EAFE NR Index = An equity index which captures large and mid cap representation across 21 Developed Markets countries around the world, excluding the US and Canada.
- **Small Cap International:** MSCI EAFE Small Cap NR Index = An equity index which captures small cap representation across Developed Markets countries around the world, excluding the US and Canada.
- **Emerging Markets:** MSCI Emerging Markets NR Index = Captures large and mid cap representation across 24 Emerging Markets (EM) countries.
- **Commodities:** Bloomberg Commodity Total Return Index = Tracks prices of futures contracts on physical commodities on the commodity markets.
- **Absolute Return:** HRFX Global Hedge Fund Index = Comprised of funds representing all main hedge fund strategies.
- **Managed Futures:** Barclay BTO50 Index = Seeks to replicate the overall composition of the managed futures industry with regard to trading style and overall market exposure.
- **High Quality US Bonds:** Bloomberg US Aggregate Bond Index = Broad-based fixed-income index used by bond traders and the managers of mutual funds and exchange-traded funds (ETFs) as a benchmark to measure their relative performance.
- **T-Bills:** FTSE 90-Day T-Bills = The index measures the performance of the average investment rate of the US T-Bills securities with the maturity of 90 days.

Important Disclosure Information

Definitions:

- Expected Nominal Return – The annual percentage return realized on an investment before adjustments like inflation or fees.
- Expected Deviation – A measure of the dispersion of returns below the expected return.
- Expected 95% Downside – The lowest return Frontier would expect to encounter over the next 12-months if all the monthly returns fell within 1.645 deviations (95% statistically confident range) of the expected real return.
- Long-term PCE estimate –The 10-year exponential moving average of annual changes in the PCE Price index as reported by the Bureau of Economic Analysis' (BEA).
- Personal Consumption Expenditures (PCE) - Personal consumption expenditures support the reporting of the PCE Price Index, which measures price changes in consumer goods and services exchanged in the U.S. economy. It is used as a measure of inflation. It is calculated by the Bureau of Economic Analysis' (BEA).

Frontier defines downside risk for asset classes as the Expected Deviation.

Frontier provides model strategies to various investment advisory firms and does not manage those models on a discretionary basis. The performance and holdings of model strategies may vary from strategies managed by Frontier.

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