

January 2025

Market Update

With 2024 in the books let's review the returns and the market forces that moved prices last year. In December, nearly every stock asset class was negative except for US large growth which was barely positive. US small caps were strongly negative and erased all of the gains they had made in the weeks following the election. Bonds and real estate were also on the whole negative as interest rates began to creep back up.

Inflation – CPI inflation started 2024 at about 3.5%. As inflation continued falling lower throughout the year (to 2.4% in September) some, including many in the Fed, thought that inflation had been tamed. So in September the Fed lowered interest rates for the first time in over four years. As if on cue, CPI inflation immediately accelerated higher with each month's rate cut, reaching 2.9% as of year-end. While the Fed was cutting the Fed Funds rate, rates controlled by the market moved higher along with inflation. As a result, assets that are sensitive to interest rates like bonds and real estate had a poor end to the year. Inflation remains a risk, especially if our spending deficits are funded via an increase in our money supply as they were in 2020, 2021, and 2022.

US Dollar – At the same time that inflation and market rates began moving higher, the US dollar did as well. The dollar bottomed in September and then moved higher to a 2024 peak at year-end. It may seem strange that the dollar rose while inflation accelerated, but this can occur if global investors prefer holding dollar denominated assets to assets denominated in other currencies while US labor and US producers demand and receive higher prices in the US. The dollar rise mostly affected international returns. For the year an international investor in the MSCI EAFE index earned an 11% return in local currencies but a US investor in the EAFE earned a 4% return in dollar terms. That 7% difference occurred entirely in the 4th quarter.

AI Momentum – The best performing equity class was again US large growth companies, represented mainly by mega cap technology names, especially those most closely related to AI.³ AI momentum was more important than any other market factor, including the high profitability/quality factor which again underperformed. As we enter 2025, the AI promise is the same as it was in 2024, and 2023: a viable generative AI tool is coming to increase productivity. Those closest to the technology are split on whether we are close to viability, but the market is priced as though it is a done deal. If generative AI doesn't deliver productivity, it will have failed despite the largest infusion of capital, talent, time, and real resources directed towards any tool in human history.

Our base case for 2025 is that GDP(Gross Domestic Product) will slow from current levels. While we didn't experience the recession many feared, higher interest rates and higher debt pressure on US households will have a slowing effect on spending and growth. Household net worth will remain bolstered by home values and investment accounts which have remained high. Inflation may have become entrenched above the Fed's 2% target. Markets and interest rates generally appear to be at appropriate levels with the exception of the largest and growthiest US companies which are trading 2-3 standard deviations above their typical valuations

Performance Summary – 2024

The S&P 500 was up 25% and small caps were up 11 %. Developed international markets gained 4% in dollar terms while emerging markets were +7%. Bonds ended up just 1% and REITs +5%. MLPs and gold performed best and were both up 26%.

Fixed Income Strategy

2024 was a year that didn't follow normal precedent in fixed income markets. It was the first year since 1990 that the Federal Reserve cut policy rates by at least 100 basis points (bps), but 10-year Treasury yields rose. This disconnect reflects the Fed's view of a potentially weakening economy versus the market's concern over stubborn inflation amidst resilient growth. Even so, investment grade fixed income returned a second consecutive solid positive yearly return. An overwhelming majority of this year's return came from the 'clip your coupon' income component as all-in yields remained higher for longer.

Fourth quarter economic data rebounded from this summer's growth scare, reflecting a strong economy and continued healthy labor market. With this good news, 10-year Treasury yields rebounded 100bps since the Fed's 50bps cut mid-September, resulting in negative returns for the quarter. Most rates along the curve rose 60-80 basis points (bps) in an environment reflecting a resilient economy. The 2-year benchmark yield rose 60bps to 4.24%, and the 10-year benchmark rose 79bps to 4.57%. The 2s/10s Treasury curve maintained a positive upward sloping bias during the quarter as the Fed continued to lower their Fed Funds target rate, while longer rates rose, resulting in additional steepening of +18bps to end the year at +32bps.

The Fed has been confident inflation would remain on a self-sustaining glide path to lower inflation and that their monetary stance was restrictive. Hence the Fed pivoted their focus to a potential rise in unemployment and lowered rates by 25bps at both their November 7th and December 18th meetings. These moves brought the total cuts to 100bps since the September 18th meeting. Despite this, the last mile of inflation remains stubbornly above the Fed's 2% target. The Federal Reserve has a cutting bias heading into 2025, but the future rate path for cuts is projected to slow and will require continued disinflation and/or a weakening labor market. Investors should expect market volatility past President Trump's inauguration as fiscal policy uncertainty is at the highest in recent memory.

Investment grade corporate spreads tightened another -9 bps during the quarter, ending the year at +80 bps. For 2024, IG corporate spreads tightened -19 bps. High yield spreads contracted -8 bps to +287 bps at quarter-end. Spreads are considered historically tight, as these levels haven't been reached in nearly a decade. Strong corporate balance sheets, and significant flows into fixed income investments during the year have contributed to these tight levels.

We continue to maintain our investment grade corporate bond focus in our strategies, but corporate spreads at near historical lows present a less favorable risk/reward profile. As a result, earlier this year we increased the government bond allocation. Another strategy change we implemented was adding a US Treasury Inflation Protection (Tip) allocation, which will help hedge uncertain future inflation outcomes. We are positioning portfolios with an overweight to duration, while yield curve positioning is relatively balanced across. Our goal is to capture what we feel are attractive yields over time as we believe all-in yields will remain higher for longer due to elevated inflation, loose financial conditions, and policy uncertainty surrounding the new administration.

Equity Income Strategy

The Equity Income strategy's primary goal is to provide reasonable income while also offering the potential for capital appreciation.

Capital preservation strategies have struggled to keep pace with current market returns as performance becomes increasingly concentrated in a few high-growth sectors, particularly technology and AI. These strategies, which focus on minimizing risk and prioritizing stable assets, were unable to capture the outsized gains from a narrow group of stocks. As a result, the strategy delivered a return of approximately -4% in the fourth quarter and about 8% for the year, underperforming compared to the broader market's more concentrated rally.

In the quarter we had no trades to report.

As always, we continue to look for opportunities to upgrade the quality of the portfolio while staying true to our disciplined valuation process.

Defensive Equity Strategy

The Defensive Equity strategy remains focused on identifying companies with stable operating results and reduced stock price volatility in the broader market.

Although we anticipated a broadening in market performance, what unfolded was a further concentration of gains, particularly within the AI sector. Companies at the forefront of AI development and infrastructure, such as those specializing in generative AI, cloud computing, and semiconductors, saw outsized growth as investor enthusiasm continued to surge.

This narrow focus reflected a belief that AI-driven innovation would deliver transformational economic benefits, overshadowing other sectors that were expected to contribute more evenly to market performance. As a result, the market's rally became even more reliant on a handful of AI-centric players, highlighting both the opportunities and risks of such concentrated leadership. Given the lack of diversification in market returns, more balanced strategies, like Defensive Equity, struggled to keep up, posting a return of approximately -5% in the fourth quarter and around 10% for the year. This underperformance underscores the challenges of navigating a market dominated by a few high-growth sectors.

In terms of portfolio allocation, our strategy maintains an overweight position in high-quality stocks while deliberately underweighting sectors that are particularly sensitive to economic cycles, such as regional banks and materials. This approach is designed to mitigate risk and prioritize stability, especially in uncertain market conditions, positioning the portfolio to weather volatility while capturing growth opportunities in more resilient areas of the market.

Additionally, we continue to hold cash and have a small position in gold.

We added no new positions in Q4.

Core Equity Strategy

In the fourth quarter of 2024, equity markets made gains to round out a strong year for the S&P 500 index which saw a 25% return in 2024. Once more, market performance this quarter was largely driven by the same technology stocks that have been propelling their growth over the past two years. Consumer discretionary, communication services, and financials rose around 14%, 9%, and 7%, respectively, while other segments, such as materials, health care, and real estate, posted around -12%, -10%, and -8% returns in contrast to the S&P 500's gain of around 2% in the 4th quarter.

For the year, markets were driven by the strong performance of technology stocks, buoyed by increased capital spending to expand data centers supporting Generative AI. Financial stocks also performed well, supported by the Federal Reserve's decision to lower short-term interest rates as inflation moved closer to its 2% target. The Consumer Discretionary sector enjoyed a solid year as U.S. consumers, still benefiting from strong employment, maintained healthy spending patterns, albeit at a more normalized pace.

Overall, the market's earlier apprehensions surrounding the November elections have dissipated, with the associated risks now fully priced out. Investors are shifting their focus toward anticipated economic growth driven by policy changes, particularly deregulation and tax cuts. This renewed optimism reflects expectations of a business-friendly environment that could stimulate corporate earnings, encourage investment, and boost overall economic activity. However, tariffs remain a significant wildcard for economic growth, as their long-term impact on trade dynamics, supply chains, and consumer prices is still uncertain.

From a portfolio standpoint, we added a few new names: Estee Lauder, CDW Corp, Thermo Fisher, Union Pacific, Xylem, and Bio-Rad. We exited positions in STMicroelectronics, Merck, Canadian Pacific, Crown Castle, and Constellation Brands in the quarter.

International Equity Strategy

International markets faced a challenging quarter but ended the year with a 4% gain. The fourth quarter marked the worst performance in the past two years, as renewed strength in the U.S. dollar caused significant turbulence across global markets. The dollar's rise created headwinds for international equities, dampening returns and exacerbating economic pressures, particularly in emerging markets and regions heavily reliant on trade.

Although the European economy has shown signs of relative strength, with high household savings rates and robust wage growth, it continues to face significant challenges. These include weak consumption, low industrial demand, and subdued investment, all primarily driven by persistently low consumer confidence. These factors are holding back economic momentum and have led to earnings falling short of expectations. Meanwhile, China's domestic issues remain a significant headwind, as the process of reigniting domestic demand is expected to take time before it positively impacts other economies. This combination of internal challenges and external pressures continues to slow the EU economic recovery.

In the quarter, we added a new position in AstraZeneca.

We exited our position in Medtronic in the quarter.

Our goal is to have a portfolio of high-quality businesses with competitive advantages that can withstand changes in economic conditions and thrive through a business cycle. Companies with established “moats” often expand market share and strengthen their business during a downturn. These are the types of companies that we continue to look for in the International Equity strategy. While we cannot predict near-term risk factors, we can control the companies we invest in. Our disciplined approach of owning high quality, financially viable and intrinsically cheap companies form the International Equity portfolio.

Value Strategy

In the fourth quarter, the Russell 1000 Value benchmark fell nearly -2%.

The financials sector led the benchmark, with about a 7% gain. Behind was the communication services sector, with a roughly 2% gain for the quarter. Meanwhile, the materials and healthcare sectors experienced the greatest underperformance, as both struggled to keep pace with broader market trends and faced significant headwinds during the period.

More specifically, the healthcare sector faced a challenging 2024 as fundamental issues and policy uncertainties created headwinds for several segments. Key challenges included drug pricing pressures and the shifting political landscape, with former President Trump naming Robert F. Kennedy, Jr.—a vocal critic of traditional healthcare services, including pharmaceutical companies—as his administration’s head of the Department of Health and Human Services. While the impact of this appointment on the healthcare industry remains unclear, it added to the near-term market uncertainty. Additionally, health insurers managing Medicare Advantage policies struggled with inadequate reimbursement rates, further straining the sector. Despite these hurdles, we remain optimistic about the sector’s long-term prospects, as it is poised to benefit from the aging population, which will drive increased demand for healthcare services and spending.

As always, valuation opportunities drive the over and underweight positioning. Currently, we see value in health care and consumer staples.

In the quarter, we added no new positions.

We exited no positions in the quarter.

Thematic Equity Strategy

Thematic is by far our most aggressive growth strategy with over 40% in Technology and 10% in Biotech –to this extent Thematic had a great quarter as investors increased their risk spectrum.

As ever, we remain vigilant in our efforts to identify new themes of secular growth that would benefit the strategy.

Covered Call Strategy

The primary goal of the Big Covered Call strategy is to obtain exposure to equities, with greater income potential at the cost of reduced upside participation.

The S&P 500 rose only 2.4% in Q4, although it had been up over 5% early in Dec. The final weeks of the year were a bloodbath, with nearly all but the top 10 largest stocks falling, many of them by a large margin. The average S&P 500 member fell ~ 2%, but the top-heaviness of the indices meant that the staggering ~16% rise of the “Magnificent 7” pulled the major indices into positive territory despite the carnage in every other area. International stocks fell nearly 7.5% as continued economic woes in Europe, China, and Canada plus the potential impact of Trump’s victory were priced in. It’s worth recapping how we reached this point before moving on to a look ahead to 2025. The terms “top 10 stocks” and “Mag 7” are used interchangeably in this piece for convenience.

In 2021 the economy overheated due to excessive fiscal stimulus, which continued even after it became clear that the Covid pandemic was controlled. Goods, food and energy inflation surged as consumers spent their stimulus checks at a time when production was shut down. Markets became volatile as investors piled into growth stocks. The Fed initially ignored the rising tide of inflation but were then forced to catch up, culminating in the steepest rate hikes in decades. By early 2022, the economy began to slow, and as supply chains healed, goods, food and energy inflation fell back to neutral level or even deflationary levels. It appeared that a mild recession might occur in 2023, followed by a return to a more typical economic cycle. However, this trajectory did not occur.

As we enter 2025, this backdrop of potential inflation creates risks. Consumers remain squeezed. Disinflation does not mean prices have dropped back to 2019 levels. Wages have risen but failed to keep up with the pace of inflation. Worse yet, official government measures of inflation fail to capture key real-world costs such as the price of a college education, the cost to buy a home (CPI and PCE data capture rent but not total home purchase costs), or the cost to purchase a portfolio capable of funding one’s retirement. The number of hours of work needed to buy a share of the S&P500 at the current average wage has never been higher, so the dream of retirement has become more of a challenge. Housing affordability (based on prices and current mortgage rates) has never been lower, so the dream of home ownership is similarly increasingly challenging for those who didn’t purchase pre-Covid.

Credit card and auto loan delinquencies have been rising to troubling levels, and once student loan debt reporting to credit bureaus resumes, those are also likely to show a high delinquency rate. Americans are doing well on average, but due to the extreme degree of wealth inequality, that average is masking a huge amount of pain. For the first time in US history, most working Americans will not achieve a higher standard of living than their parents. If income growth sustains, spending will likely continue, but eventually the savings rate must normalize and if unemployment rises, belt tightening must occur quickly.

Inflation pressure on consumers creates downside risk to consumption, but it also creates headwinds if the economy re-accelerates. Much as prices may never return to 2019 levels, it seems increasingly unlikely that interest rates will “go back to normal” in the sense that they may not hit their post-GFC/pre-Covid average levels again. In fact, the period of ultralow interest rates (below zero in parts of the world) was the aberration, and rates are now much closer to normal! Market participants are only just beginning to process the idea that the Zero Interest-Rate Policy/Quantitative Easing (ZIRP/QE) era

may be gone for good.

Meanwhile, the equity market boost from the expected rate cutting cycle was priced in at record speed, with an incredible ~40% rally in 8 months following the Powell Pivot. The market reaction to the interest rate policy transition from hikes to cuts was unusually intense. Investors rushed to buy at a frenetic pace, exceeding 2021's record level of inflows. Fed data shows that households now have more equity exposure on their balance sheet as a percentage of total assets than ever before. This is problematic, because like the high valuations with which such equity enthusiasm intuitively coincides, these periods tend to be followed by abnormally low returns and higher volatility thereafter.

If we do not get the rate cuts that have been anticipated, then downward volatility would be the likely result. It now looks as if there may be only a very shallow series of cuts rather than the steep descent that markets had foreseen a few months ago. In fact, when the Fed finally began to cut rates in Sep 2024 (nearly a year after Powell's pivot) the 10yr yield reacted by rising... Since the first rate cut, the 10yr yield has gone up about 1%, a rare occurrence that could mean that investors are beginning to demand higher compensation to bear our credit risk, or that investors no longer believe that the Fed will keep inflation near its stated target of 2%. Neither interpretation would be positive, but neither would precipitate an immediate crisis.

Why then, has the S&P500 delivered two of its best years ever? The simple answer is P/E multiple expansion combined with an extreme degree of concentration. Investors have decided that they are willing to pay more for some large companies than they were pre-Covid, by a substantial margin. This premium does not apply across the board to all financial assets; international stocks and small-to-mid cap stocks are trading near their long-term average valuations. It is only the S&P500 (with ~35% weight in the top 10, mainly tech stocks) and the Nasdaq 100 (52% weight in the top 10, the same megacaps) that command such a premium valuation. The Mag 7 companies are incredibly profitable, and some continue to grow rapidly, but they are also incredibly expensive, and that makes US large market-cap-weighted indices expensive, across any valuation metric one cares to use.

Prior episodes of extreme market concentration (in energy stocks, banks, the nifty fifty, or the prior tech bubble) have all ended poorly. When an index becomes concentrated in a particular sector or subset of stocks, it loses the diversification benefit that creates the "magic" of long-term returns. The index starts to behave more like an individual stock, with higher highs and lower lows than a more balanced portfolio. The subset of stocks driving the index gains can keep on outperforming for a while, but the larger a company the harder it is to grow. The truth is that historically, growth rates have been highly mean reverting. Most companies are eventually outcompeted and die. A good portfolio will keep winning while individual stocks fall by the wayside, because a portfolio trims past winners that have become bloated and expensive and adds to tomorrow's potential rising stars. Maintaining diversification by rebalancing is a key discipline.

Investors have correctly identified a set of stocks with excellent characteristics, but they are assuming this strong performance will persist for many more years. That is one possible outcome, but due to the lofty expectations embedded in current prices, even future earnings that seem stellar on the surface could lead to a pullback if they disappoint relative to the extremely high bar that has now been set. The best company can become a bad investment at a high enough price.

The market's extreme top-heaviness sets up many interesting and unusual dynamics. One is that Dec saw the lowest breadth readings on record, with a prolonged period where nearly all stocks fell but the

index rose anyway, powered by the top 10. The top 10 are driving the entire index and the gap between the 10 and the 490 (and small/mid cap and international stocks) just keeps growing. One theory, excellently articulated by Simplify's Mike Green, is that the rise of passive investment is driving this ever-widening spread. Active managers cannot own enough of the Mag 7 to keep up with their benchmarks, so they keep lagging "the market" (which has come to mean the S&P500 index rather than the average stock), so investors keep on firing them and putting their money into passive ETFs. Those passive ETFs mechanically take ~40 cents of every dollar (completely disregarding valuation) and buy more of the top 10, inflating them even further, leading to the next round of flows out of active funds, in a vicious feedback loop.

In theory, passive is meant to be a free ride on the back of an efficient market. However, this assumes that "passive" investors do not trade and that the market will always be efficient, even when there are fewer (or even no) valuation-conscious investors pushing prices towards their fundamental value. Some, including heavyweights like AQR's Cliff Asness are beginning to wonder whether the assumption of market efficiency can survive when passive, valuation agnostic funds control over half of all assets and may represent as much as 90% of all new flows. Who is left to stand against the tide of money flowing into the top 10 stocks at any price? In fact, the higher their prices, the higher their weight in the index, and the higher the proportion of each new dollar invested they will command.

Mike Green's work suggests that the indices will keep getting more concentrated in the largest stocks and their valuations will keep on climbing, to levels that would have seemed impossible or absurd based on market history, before crashing. Eventually, economic gravity, the tie between share prices and fundamentals like earnings, will re-exert control, but the path between now and then might be unpleasant.

The outcome from this period of speculation and market concentration is likely to be brutal. Those who feel they must obtain the S&P 500 return can easily do so, but will they be happy with the results a decade hence? Diversifying into other asset classes has been a pure performance drag over the last decade, so it's easy to dismiss the idea. A diversified portfolio may well continue to perform worse than the top 10 stocks in the near term, given their strong momentum and passive-flow dynamics. However, those investors holding reasonably priced assets may have a stronger advantage over the long term if history has taught us anything. When the tide turns, there is no way for all of the investors crowded into the Mag 7 to exit at the same time (at least not at the prevailing prices).

Turning to the options markets, premia in the major indices rose over the quarter but remain below the average levels of the post-Covid period. There are a myriad of strategies that have become very popular with investors, most of which sell options on a monthly, weekly, or even daily basis. As a result, it has become more important than ever to monitor options prices and ensure that the level of risk premium remains appropriate. If options prices fall too far, then we may choose to sell fewer options than normal, covering only half or even a quarter of our shares. If simultaneously leaning bearish, we'd also raise our cash level to maintain the net beta and volatility of the portfolio somewhere close to the normal range. If leaning more bullish, then simply holding uncovered stock would be the appropriate approach. Should options prices fall so far that we judge the risk premium to have turned negative, then we might hold stock and purchase some protective puts or cheap calls at discounted prices.

This type of flexible approach is crucial now that so much capital has flowed into options-selling strategies.

This quarter, we kept approximately 20% of our capital invested in the Russell 2000 via the IWM ETF. While small caps are more vulnerable during recession, the relative price of the Russell compared to the S&P500 remains attractive. A recession would cause the position pain, but for now, the upside still looks more favorable. Additionally, allocating a portion of assets to the Russell 2000 helps to lower the concentration risk in megacap tech that remains a concern in the S&P. Finally, option prices in IWM are higher, offering greater return potential. We maintained a high cash level (above 10% on average across accounts) thus far in 2024, which was a drag but provides flexibility in the event of a market dislocation. Managing volatility via cash level and strike price selection for our call sales has outperformed put option purchases so far and remains the risk-management plan. However, we are weighing the potential benefits of adding some longer-dated protection on the downside given the cheap prices of 6m-1yr protective put options.

Investors in the growth and accumulation phase of their investing life cycle or those with a strong bullish outlook may wish to look at other strategies while those in the distribution phase or with a more neutral market outlook may find Covered Call an attractive complement to their traditional portfolios.

Sources & Disclosures

All earnings data comes from Standard and Poors' S&P 500 Earnings and Estimates Report as of 12/31/2024

All economic data comes from Federal Reserve Economic Data (FRED) as of 12/31/2024

Asset class performance numbers come from Morningstar as of 12/31/2024

The S&P 500® is widely regarded as the best single gauge of large-cap U.S. equities. There is over USD 9.9 trillion indexed or benchmarked to the index, with indexed assets comprising approximately USD 3.4 trillion of this total. The index includes 500 leading companies and covers approximately 80% of available market capitalization.

Treasury yields are yields on debt obligations issued by the U.S. Government. U.S. Treasuries can be purchased individually.

The Russell 2000 Index® measures the performance of the 2,000 smallest companies in the Russell 3000 Index.

The iShares Russell 2000 ETF (the IWM ETF) seeks to track the investment results of an index composed of small-capitalization U.S. equities.

The MSCI EAFE International Stock Index measures the performance of the large and mid-cap segments of

developed markets, excluding the US & Canada equity securities. It is free float-adjusted market-capitalization weighted.

Market Beta (Beta) is a measure of a stock's volatility in relation to the overall market. By definition, the market has a beta of 1.0, and individual stocks are ranked according to how much they deviate from the market.

The Nasdaq-100 Index (NDX®) defines today's modern-day industrials—comprised of 100 of the largest and most innovative non-financial companies listed on the Nasdaq Stock Market based on market capitalization.

The Russell 1000 Value Index measures the performance of the large-cap value segment of the US equity securities. It includes the Russell 1000 index companies with lower price-to-book ratios and lower expected growth values. It is market-capitalization weighted.

The Cboe Volatility Index, better known as VIX, projects the probable range of movement in the U.S. equity markets, above and below their current level, in the immediate future. Specifically, VIX measures the implied volatility of the S&P 500® (SPX) for the next 30 days.

Standard deviation is a statistical measurement that shows how spread out a set of data is. It is used to assess risks of investments.

The Magnificent Seven stocks are a group of high-performing and influential companies in the U.S. stock market: Alphabet, Amazon, Apple, Meta Platforms, Microsoft, NVIDIA, and Tesla.

The price-to-earnings (P/E) ratio measures a company's share price relative to its earnings per share (EPS). Often called the price or earnings multiple, the P/E ratio helps assess the relative value of a company's stock.

A "Moat" is a term that refers to a business's ability to maintain a competitive edge over its competitors.

Investors should be aware that there are risks associated with options. Additionally, options transactions produce tax consequences when closed. Market related actions, political issues, and economic issues can adversely affect the option market. These factors could restrict, halt, suspend, or terminate option positions written (sold) or purchased, which would prevent us from an ability to act or react to any of these conditions. Note: Options involve risk and are not suitable for everyone. Prior to buying or selling options, you should read the option disclosure document, Characteristics and Risks of Standardized Options, which can be obtained on the Options Clearing Corporation website at <https://www.theocc.com/about/publications/character-risks.jsp>, or by contacting your custodian.

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