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LETTER OF VALUE

Ruminations for investors seeking to enhance their wealth using the principles of
VALUE INVESTING

TO OUR BUSINESS PARTNERS:

Tariffs and trade wars. Armed conflicts in the Middle East and Eastern Europe. Uncertainty with regards to when the U.S. Federal Reserve might cut the fed funds rate. Inflation pressuring the consumer. A ballooning domestic national budget deficit with our federal government's spending exceeding its revenues by \$1.8 TRILLION in fiscal 2024 and up 8% from the prior year.

But notwithstanding all these worries, stocks are trading near record valuations across many valuation metrics, including the price-to-earnings per share (P/E) multiple, at a time when corporate profit margins are also near all-time highs. In other words, we have peak multiples on peak profitability.

As the S&P 500 index continues to grind higher, many are feeling the pressure to, if not beat it, then at least keep up with the 'market'. Domestic households have almost one-half of their financial assets in stocks, which too is near the highest level ever, even though stocks are very expensive.

This reminds us of a quote by the former Chief Executive Officer of Citigroup, Chuck Prince, who in July of 2007 famously said:

"When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance."

Well, as we saw in the ensuing bear market of 2008-2009, the music eventually stopped playing, and people eventually stopped dancing.

The S&P 500 is priced at nearly 29 times trailing earnings. This is an earnings yield (inverse of the P/E ratio) of 3.4%, which is an unacceptable risk-to-reward, especially when considering the 2-month U.S. Treasury bill, which is as good as cash and thereby essentially risk-free, is yielding 4.4%.

We find it remarkable that the ten largest companies by market cap account for approximately 40% of the S&P 500's value and that together they helped power the index to a 25% return in 2024.

In addition to this extreme concentration, Apollo Global Management notes that these ten companies are accounting for a record-high share of earnings. Notably, eight of these ten companies are technology stocks.

Apollo goes on to note the following: *"The extreme index concentration in tech is obviously not good for investors seeking to diversify their investments across 500 different companies. Anyone investing in the S&P 500 index today is basically making a bet on the Magnificent 7 stocks propelling even higher."*

The percentage weights of the top ten companies of the index and their P/E ratios and share price performances in 2024 is as follows:

- NVIDIA – 7.5%, 53, +171%
- Microsoft – 7.0%, 39, +13%
- Apple – 6.0%, 32, +31%
- Amazon – 4.0%, 37, +44%
- Alphabet – 3.5%, 20, +36%
- Meta – 3.0%, 28, +66%
- Broadcom – 2.4%, 103, +110%
- Berkshire Hathaway – 1.7%, 13, +27%
- Tesla – 1.6%, 172, +63%
- JPMorgan Chase – 1.5%, 14, +44%

Further illustrating just how concentrated this index has become, the median stock in the S&P 500 was up 'only' 10%, and one-third of the stocks in the index were *down*, in 2024.

We do not strive to outperform a benchmark or index but rather generate attractive absolute returns over time with **lower risk**. We do not want to overpay to be fully invested.

Job number one for your Business Partners is to preserve your capital, and if we are able to protect you on the downside, then the upside should take care of itself.

In the current environment, we are defensively positioned, with elevated levels of cash and cash-equivalents, because a) we continue to sell overpriced holdings, and b) there is a dearth of good businesses trading at cheap prices.

An example of a stock that we have continued to reduce the position size of is McKesson. (This is not a recommendation to buy or sell the stock).

There was a time when the country's largest pharmaceutical distributor was one of our cheapest holdings. Uncertainty tied to resolution of the national opioid litigation overshadowed the company's attractive underlying characteristics and is what presented us with the opportunity to buy McKesson in the first place.

After this legal issue was resolved, the stock price rose as investors began to focus on McKesson's strong pharma sales growth and solid free cash flow generation.

More recently, McKesson's 25% total return year-to-date reflects the investment community's treatment of the company as a haven within the broader health care industry, which is contending with quite a bit of uncertainty from a policy standpoint.

The result of this is that McKesson is now one of our most overvalued holdings. Company insiders appear to agree with us, as they have sold nearly \$50 million worth of the stock over the past six months alone, with no purchases, including the Chief Executive Officer's sale of \$14 million of the shares in June of 2025.

So, we now find ourselves with a stock that discounts many of the positives, hence the reason why we have further reduced the position size.

Your Partners are not perma-bears. Far from it. We would love to be fully invested, but only if we are compensated for taking on risk. In the meantime, we are not standing still. We continue to research companies and add to an on-deck list of stocks that we are ready to invest in when they reach our buy points.

One company recently reached our buy point, so we acted: Lennar, which is one of the largest homebuilders in the country. (This is not a recommendation to buy or sell the stock).

The stocks of companies in the homebuilding business have come under significant pressure as investors worry about the outlook for housing amid affordability constraints.

However, Lennar is taking steps to make homes more affordable for consumers while at the same time reducing their own cost structure to protect their profitability. And notwithstanding the near term uncertainty, the positive long-term outlook for homebuilders appears to remain intact, with

U.S. housing supply having struggled to meet demand.

Moreover, Lennar, and the industry, has changed for the positive throughout the years, with homebuilders having gone from being land developers that made money by putting houses on land to make their profits on lot sales, to now making a profit off building the home, and their balance sheets have vastly improved.

Lastly, Lennar is run by an Executive Chairperson and Co-Chief Executive Officer who because he owns billions of dollars' worth of stock brings an owner-operator mentality to the table, and management's compensation is tied in part to the achievement of certain return on invested capital metrics as well as maintaining the strength of the balance sheet. Therefore, insider interests are aligned with those of public shareholders.

We thank you, our clients, centers-of-influence, and business associates, for your ongoing trust and confidence.

"You make most of your money in a bear market, you just don't realize it at the time."

-Shelby Davis

Andy Ramer, CFA
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