



July 2025

"Enduring great companies preserve their core values and purpose while their business strategies and operating practices endlessly adapt to a changing world."

– Jim Collins, *Good to Great*

INVESTMENT PERSPECTIVES

Speculation, Inflation, and AI Valuation

As the first half of 2025 drew to a close, markets pivoted sharply from last year's "quality comeback" to a full-throttle embrace of speculation. An abrupt rally from the April 8 low catapulted the most unprofitable companies to significant gains, more than double the return of profitable peers, and pushed high-beta¹, story-driven names such as Tesla to eye-watering valuation multiples. At the same time, Washington's policy mix turned decisively inflationary: higher across-the-board tariffs, tighter immigration rules, and a fresh dose of fiscal stimulus have together rekindled price-pressure risks just as the Federal Reserve nears the limits of its soft-landing playbook. Intensifying these crosscurrents is the investor stampede into artificial intelligence; while the technology's long-term promise is undeniable, valuations in the sector increasingly echo late-1990s exuberance, even as many headline AI firms struggle to convert massive R&D outlays into cash flow.

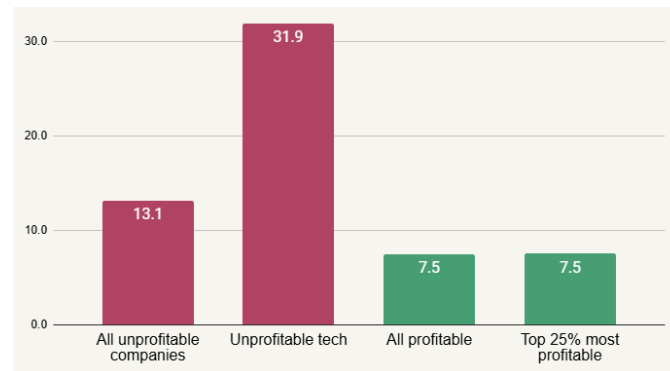
Against that backdrop, this quarter's *Investment Perspectives* examines three forces we believe will define market dynamics in the year ahead: the market's renewed "risk-on" appetite and what history tells us about its shelf life; policy-driven inflation and why businesses with durable pricing power and capital-light models are the best guardians of real wealth; and the difference between chasing AI hype and owning the indispensable infrastructure that will power the technology's eventual winners. As always, our focus remains on companies with wide economic moats, strong balance sheets, and management teams that allocate capital with discipline. Amid headline volatility and narrative-driven swings, patience, selectivity, and an unwavering commitment to fundamental value remain our most reliable tools for protecting and compounding your capital.

Narrative Over Numbers

The first half of 2025 has delivered a compelling case study in risk-on behavior, with the most dramatic evidence emerging from the stark outperformance of unprofitable companies over their profitable counterparts. Since the market's April 8 low, 858 unprofitable companies in the Russell 3000 Index have delivered average gains of 36%, outperforming their profitable peers. This phenomenon has accelerated dramatically in Q2 2025, where companies with the worst profit margins became the market's biggest winners, with unprofitable technology companies posting gains of approximately 30% compared to just 15% for their profitable peers. The appetite for speculation intensified as investors demonstrated a clear preference for potential over proven performance, rewarding companies based on narrative and growth prospects rather than current financial metrics.

¹ **High-beta:** Beta measures how much a stock's price moves relative to the overall market (beta = 1.0 moves in line with the market). "High-beta" stocks, typically >1.3, swing more than the market, outperforming in rallies but falling harder in sell-offs, making them favored vehicles for speculative risk-taking.

Q2 2025 US Stock Returns by Profitability



Source: Facet, Bloomberg US 3000 Index

The structural deterioration in quality has reached alarming levels, creating perfect conditions for this risk-on environment to flourish. Nearly 43% of Russell 2000 companies reported negative earnings as of December 2024, up from just 14% in 1994. This dramatic shift reflects both higher-quality companies staying private longer and the increasing representation of speculative sectors like biotech, pharma, and software whose bottom lines are less linked to broader economic conditions. The quality gap has become particularly pronounced among companies that went public since 2020, with 70% of these nearly 500 companies showing negative trailing earnings per share.

Tesla serves as a perfect case study of how high-beta, story-driven stocks behave during risk-on periods, while also highlighting the premium investors are willing to pay for transformational narratives. Despite reporting mixed Q1 results and facing ongoing concerns about vehicle delivery growth, Tesla surged as investors focused on CEO Elon Musk's reiterated timeline for Robotaxi deployment and promises of lower-cost vehicle launches. The company's current valuation reflects extraordinary optimism about its autonomous driving technology and energy storage business, trading at roughly 130 times forward earnings compared to traditional automakers at 6-8 times. What justifies that premium? The market is effectively discounting multibillion-dollar optionality in three unproven engines: 1) a profitable robotaxi network slated for launch later this year, 2) exponential monetization of Full Self-Driving software, and 3) energy-storage scale-up toward 50 GWh annually. If even a fraction materializes, current valuation multiples could prove sustainable. If execution falters, the valuation gap leaves little margin for error. In short, Tesla has become the quintessential "risk-on" bellwether where fundamentals are thin, the story is rich, and virtually everything is already priced in.

The timing of today's speculative environment strengthens the case for quality investing, as current market conditions mirror historical patterns where defensive stocks eventually reassert their superiority. Research shows that while quality companies may underperform during early-stage market recoveries and periods of extreme risk-taking, they consistently outperform in ~86% of five-year rolling periods and ~92% of all longer-term investment horizons. Most importantly, quality stocks demonstrate asymmetric risk profiles. They capture more upside during bull markets while providing crucial downside protection during inevitable corrections, outperforming during drawdowns. As the current cycle of unprofitable company outperformance faces structural headwinds from potential policy changes and the eventual need for cash flow generation, our patient capital approach positions us to benefit from the market's inevitable return to rewarding fundamental business quality over narrative-driven speculation.

Inflation Trifecta: Tariffs, Labor Crunch, and Fiscal Fuel

The economic landscape ahead presents a compelling case for renewed inflationary pressures, driven by three key policy pillars that are reshaping our economic environment. Current tariff policies, including the recent announcement of 10% tariffs on most trading partners and 60% on China, are estimated to add 1.4 to 2.2 percentage points to inflation. These trade measures, now averaging 11.5% through 2029, represent the highest tariff levels since 1909. Meanwhile, immigration restrictions are removing critical labor supply from the economy, with new policies expected to cost American families an additional \$2,150 annually by 2028. The Federal Reserve has noted that these deportation policies are already slowing economic growth by reducing the labor force. Finally, the recently passed One Big Beautiful Bill, extending tax cuts and increasing spending, continues the pattern of fiscal expansion that research shows contributed 42% to the 2022 inflation spike. Together, these policies create a potent mix: reduced supply capacity through immigration restrictions, higher input costs through tariffs, and continued demand stimulus through fiscal policy.

In this environment, businesses with genuine competitive advantages, what Warren Buffett calls "economic moats", become invaluable portfolio anchors. History demonstrates that companies with pricing power consistently outperform during inflationary periods. Research spanning eight inflationary episodes since 1940 shows that high-quality stocks beat the S&P 500 in six of eight periods, while cheaper high-quality stocks outperformed in seven of eight cases. Quality companies, defined by strong profitability metrics and efficient capital usage, possess three critical advantages: the ability to pass through higher input costs to customers, reduced reliance on external financing during periods of rising interest rates, and sustainable competitive positioning that competitors cannot easily replicate. These businesses leverage their brand strength, switching costs, or network effects (where each incremental user makes the product or service more valuable for all users, reinforcing demand and loyalty) to maintain customer loyalty even as prices rise. Consider how companies like Starbucks can incrementally raise prices during inflationary periods without losing significant market share, or how Apple's pricing power stems from its ecosystem's switching costs and brand loyalty.

Quantitative evidence strongly supports the resilience of quality companies during periods of rising inflation. For example, during the 2021–2022 inflationary surge, the MSCI World Quality Index outperformed the broader market by approximately 5–7 percentage points annually. Companies with significant pricing power, particularly in sectors like consumer staples and healthcare, maintained average profit margins of 18–20%, compared to 12–14% for the overall market. This ability to pass on higher costs to customers not only protected margins but often led to margin expansion. Historical analysis echoes these results: during the high-inflation 1970s, quality stocks outperformed the market by about 6% per year. These patterns demonstrate that quality companies, especially those with pricing power, consistently outperform and preserve profitability in inflationary environments.

As we position portfolios for the challenges ahead, we remain focused on businesses that combine three essential characteristics: proven pricing power, capital-light business models, and strong balance sheets. These companies don't just survive inflation. They often emerge stronger, having used the economic disruption to widen their competitive moats while weaker competitors struggle with margin compression. The current environment, with its policy-driven inflationary pressures, offers an ideal opportunity to identify and invest in these exceptional businesses before their advantages become fully recognized by the broader market. While short-term volatility is inevitable, history shows that quality businesses with enduring competitive advantages provide the most reliable path to preserving and growing purchasing power during inflationary periods.

Artificial Intelligence: Navigating the Hype While Building for the Future

The artificial intelligence revolution has captured headlines and investor attention like few technologies before it but distinguishing between transformative potential and speculative excess remains critical for prudent investing. Despite massive investments, leading AI companies struggle with monetization: OpenAI expects to lose \$5 billion in 2025 despite its \$100+ billion valuation, while tech giants have

collectively spent tens of billions on AI infrastructure with limited revenue growth to show for it. The parallels to the dot-com bubble are unmistakable. Companies are being valued on AI potential rather than proven profitability, with traditional metrics like return on investment taking a backseat to technical capabilities. However, unlike the late 1990s, today's AI leaders generally possess strong fundamentals, substantial cash reserves, and existing profitable business models that provide a foundation for long-term success. The key difference is that current leaders like Microsoft, Google, and Amazon have delivered actual earnings growth alongside their AI investments, suggesting a more sustainable foundation than the dot-com era's "hope over reality" mentality AI investment trends. While we expect significant volatility as the market sorts winners from losers, the underlying technology remains genuinely transformative for long-term economic productivity.

Investing in "World-Changing Technology"

Studying Technological Shifts and Value Creation Over the Last Century

	1900	2000	2024
World Changing Technology	Automobile	Wi-Fi	AI
Ubiquity	Ubiquitous Transportation Technology	Global Ubiquitous Standard	Emerging Trend
1st Order Beneficiary: Investment Example	US Auto Manufacturers	Wireless Router Manufacturers	GPU + Hardware Manufacturers
1st Order Beneficiary: Investment Example Outcome	Consolidation and Aggressive Competition	Commoditization	To Be Determined
2nd Order Beneficiary: Theme Enabled by Technology	Suburbanization: Big-Box Retail	Rich Content Delivery: Streaming Video	Automation and GenAI: High Efficiency Labor
2nd Order Beneficiary: Investment Example Outcome	WALMART: 1,622x Return ('80-'20) FORD: 23x Return ('80-'20)	NETFLIX: 519x Return ('02-'20) CISCO: 4x Return ('02-'20)	???

Source: Morgan Stanley

Rather than chasing the latest AI darling or trying to pick tomorrow's ChatGPT, our investment approach focuses on the essential infrastructure powering this technological shift, what we call the "picks and shovels" strategy. Just as hardware suppliers and infrastructure providers proved more reliable investments than individual internet companies during the dot-com era, today's AI infrastructure companies offer more predictable revenue streams and lower execution risk. These businesses benefit from the AI boom regardless of which specific applications ultimately succeed, much like how companies selling mining equipment profited during gold rushes while most individual prospectors failed. These companies typically operate in oligopolistic markets with high barriers to entry, generating steady cash flows and maintaining pricing power even during economic uncertainty. By focusing on the foundational layer rather than speculative applications, we position portfolios to benefit from AI's growth while avoiding the winner-take-all risks inherent in software and services.

Our infrastructure-focused approach emphasizes companies with fortress-like balance sheets and proven operational excellence, characteristics that become especially valuable during market volatility. We seek similar financial strength among infrastructure providers, prioritizing companies with minimal debt burdens, consistent free cash flow generation, and management teams with track records of prudent capital allocation. These businesses often possess decades-old relationships with customers, specialized technical expertise that's difficult to replicate, and recurring revenue models that provide stability during economic downturns. As investment focus shifts from foundational AI training to practical applications and enterprise deployment, infrastructure companies are well-positioned to benefit from both phases of the AI adoption cycle. Quality becomes paramount when navigating speculative markets. Companies with strong balance sheets can invest counter-cyclically during downturns, acquire distressed competitors, and emerge stronger when markets recover. This approach has historically outperformed during periods of

technological transition, providing both downside protection and upside participation as transformative technologies mature.

While AI's long-term impact on productivity and economic growth appears undeniable, the path forward will likely include significant volatility as markets recalibrate expectations with reality. Current AI stock valuations may not indicate a bubble according to some strategists, but the disconnect between massive capital investments and tangible returns creates risks for momentum-driven positions. Our infrastructure strategy acknowledges both AI's transformative potential and the inevitable market corrections that accompany major technological shifts. By maintaining exposure to high-quality infrastructure providers rather than speculative AI applications, we participate in the technology's growth while reducing single-company and winner-takes-all risks. We remain optimistic about artificial intelligence's long-term prospects while maintaining the discipline to invest in sustainable business models rather than speculative narratives, an approach that positions our clients to benefit from this technological revolution regardless of short-term market sentiment.

In Conclusion

Extreme risk-on swings, policy-driven inflation pressures, and headline-grabbing AI valuations have all competed for investors' attention this quarter. Yet our playbook remains unchanged: safeguard capital first, compound it steadily second. We continue to favor companies that meet three tests: defensible moats, proven pricing power, and balance-sheet strength. Those characteristics have historically delivered both resilience when speculation unwinds and participation when genuine growth opportunities emerge. By emphasizing quality over hype, pricing power over policy noise, and the picks-and-shovels of AI over lottery-ticket applications, we believe the portfolio is appropriately positioned for whatever combination of volatility and opportunity the back half of 2025 may bring.

Thank you for your ongoing trust and partnership. We welcome your questions and conversations at any time, whether about current market dynamics or your specific financial objectives. By staying disciplined, patient, and focused on fundamental value, we can turn short-term volatility into opportunities for sustained, long-term growth.

DISCLOSURES:

As of June 30, 2025, Hutchinson Capital Management (HCM) held:
55 shares of Tesla Inc (TSLA)

As of June 30, 2025, TSLA closed at \$317.66

As of June 30, 2025, Hutchinson Capital Management (HCM) held:
124,808.98 shares of Apple Inc Class A (AAPL)

As of June 30, 2025, TSLA closed at \$205.17

As of June 30, 2025, Hutchinson Capital Management (HCM) held:
161,786.7912 shares of Starbucks Corp (SBUX)

As of June 30, 2025, SBUX closed at \$91.63

As of June 30, 2025, Hutchinson Capital Management (HCM) held:
67,707.8432 shares of Microsoft Corp (MSFT)

As of June 30, 2025, MSFT closed at \$497.41

As of June 30, 2025, Hutchinson Capital Management (HCM) held:
64,809.08 shares of Amazon com Inc (AMZN)

As of June 30, 2025, AMZN closed at \$219.39

As of June 30, 2025, Hutchinson Capital Management (HCM) held:
142,465 shares of Alphabet Inc Class A (GOOGL)

As of June 30, 2025, GOOGL closed at \$176.23

As of June 30, 2025, the following were the ten largest holdings of HCM:

Name of Issuer	% of Equity Portfolio	6/30/2025 Closing Price
Berkshire Hathaway Inc Class B	6.72%	\$485.77
Microsoft Corp	6.47%	\$497.41
Progressive Corp	5.12%	\$266.86
Bank of America Corp	5.05%	\$47.32
Apple Inc	4.89%	\$205.17
Alphabet Inc Class A	4.81%	\$176.23
Jacobs Solutions Inc	3.60%	\$131.45
WR Berkley Corp	3.32%	\$73.47
Adobe Inc	3.26%	\$386.88
Waters Corp	3.24%	\$349.04

HCM's investment decision making process involves a number of different factors, not just those discussed in this document. The views expressed in this material are subject to ongoing evaluation and could change at any time.

Past performance is not indicative of future results, which may vary. The value of investments and the income derived from investments can go down as well as up. It shall not be assumed that recommendations made in the future will be profitable or will equal the performance of the securities mentioned here. While HCM seeks to design a portfolio which reflects appropriate risk and return features, portfolio characteristics may deviate from those of the benchmark.

Although HCM follows the same investment strategy for each advisory client with similar investment objectives and financial condition, differences in client holdings are dictated by variations in clients' investment guidelines and risk tolerances. HCM may continue to hold a certain security in one client account while selling it for another client account when client guidelines or risk tolerances mandate a sale for a particular client. In some cases, consistent with client objectives and risk, HCM may purchase a security for one client while selling it for another. Consistent with specific client objectives and risk tolerance, clients' trades may be executed at different times and at different prices. Each of these factors influence the overall performance of the investment strategies followed by the Firm.

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