



October 2025

"Bull markets are born on pessimism, grown on skepticism, mature on optimism, and die on euphoria."
– Sir John Templeton

INVESTMENT PERSPECTIVES

Valuation, Concentration, and the Return to Fundamentals

As the third quarter of 2025 concluded, markets continued their impressive climb from April's lows, with the S&P 500 reaching new all-time highs despite persistent uncertainties around trade policy, labor market health, and monetary policy direction. The 34% rally since early April has pushed valuations to levels that demand careful scrutiny: the Shiller price-to-earnings ratio¹ now stands at 40x, well above its 35-year average of 27x and approaching levels last seen during the dot-com bubble. More concerning than the headline multiple is the narrow leadership driving these returns with the Magnificent Seven technology stocks contributing over 60% of the S&P 500's gains, while the equal-weighted index lagged significantly.

Against this backdrop, this quarter's *Investment Perspectives* examines three critical considerations for navigating today's market environment: what elevated valuations and extreme concentration mean for portfolio construction and expected returns, whether the artificial intelligence investment cycle is approaching an inflection point as reality confronts expectations, and why the market's apparent calm masks underlying fragilities that favor defensive positioning. As always, our focus remains on companies with sustainable competitive advantages, reasonable valuations relative to growth prospects, and management teams that prioritize long-term value creation over short-term narrative. In an environment where speculation occasionally overshadows fundamentals, discipline, patience, and a commitment to quality become our most reliable tools for protecting and compounding capital.

Valuation and Concentration Extremes

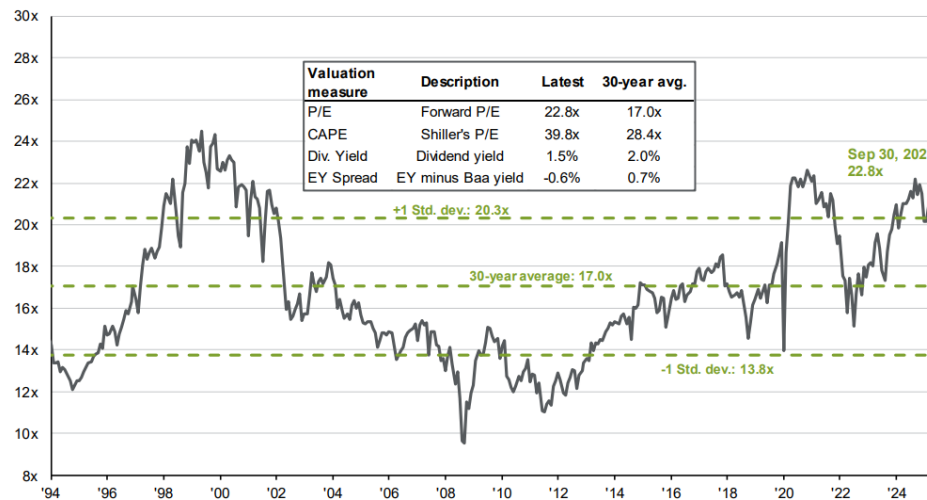
The current market environment presents investors with a valuation challenge that extends beyond simple price-to-earnings ratios. While the Shiller P/E of 40x raises questions, the more pressing concern lies in the extreme concentration of market returns and what this implies for future performance. The top nine technology companies in the S&P 500, each with market capitalizations exceeding \$1 trillion, now represent nearly 40% of the index's total value. This concentration rivals peaks seen during the dot-com bubble, though today's leaders possess fundamentally stronger businesses with actual earnings, substantial cash flows, and dominant market positions. The critical question isn't whether these companies deserve premium valuations, but rather whether their current multiples adequately reflect both their growth prospects and the execution risks inherent in maintaining dominance across rapidly evolving technology landscapes.

Historical analysis provides sobering context for today's valuation levels. Markets trading at Shiller P/E ratios above 35x have historically delivered subsequent 10-year annualized returns in the mid-single

¹ The Shiller P/E (also called CAPE ratio) measures the S&P 500's price relative to average inflation-adjusted earnings over the past 10 years, providing a longer-term valuation perspective than traditional P/E ratios.

digits, well below the long-term average of 10%. Research shows that starting valuations are one of the most reliable indicators of future returns over longer time horizons. While elevated valuations don't preclude continued gains (earnings could grow faster than expected, or multiples could remain elevated if interest rates stay low) they do suggest more modest forward returns compared to historical norms and reinforce the importance of selectivity in portfolio construction. More importantly, periods of extreme concentration have typically resolved through either multiple compression in market leaders or significant outperformance from broader market segments, or both. The 2000-2002 bear market saw the Nasdaq fall 78% from its peak, but what's often forgotten is that the subsequent 2003-2007 recovery was led not by former technology darlings but by energy, materials, and previously unloved value stocks. Today's concentration suggests similar potential for leadership rotation, though the timing and catalyst remain unknowable.

S&P 500 Index: Forward P/E ratio



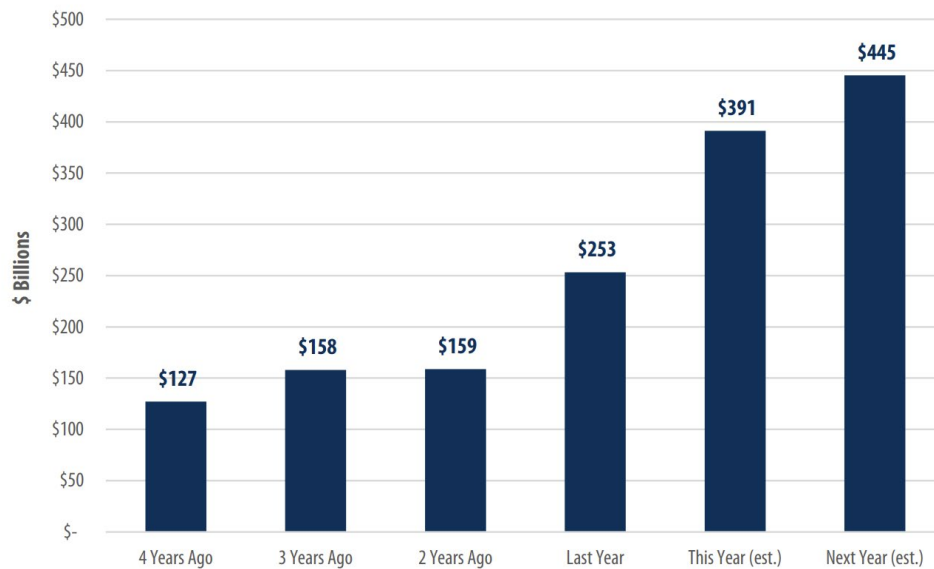
Source: J.P. Morgan

The implications for portfolio construction are clear: while momentum and concentration can persist longer than seems rational, building portfolios that depend on sustained multiple expansion in already-expensive stocks is a bet on continued exceptionalism rather than sound risk management. We favor a more balanced approach that maintains exposure to quality technology leaders while emphasizing businesses trading at more reasonable valuations relative to their growth prospects. This positioning sacrifices some upside if today's leaders continue their dominance but provides crucial protection if market leadership broadens or if expensive growth stocks experience the multiple compression that typically follows extreme valuations. In an environment where the S&P 500's forward P/E implies high-single-digit returns over the coming decade, finding pockets of the market trading at more attractive valuations becomes essential for achieving reasonable risk-adjusted returns.

The AI Investment Cycle: Separating Signal from Noise

The artificial intelligence narrative that dominated 2024 entered a more complex phase in 2025, as massive capital deployment confronted growing questions about monetization timelines and return on investment. Technology companies collectively are spending close to \$400 billion annually on AI infrastructure, yet tangible revenue generation remains concentrated in a narrow set of applications. Recent analysis from Bain & Company projects an \$800 billion shortfall between AI-related capital expenditures and incremental revenues through 2028, suggesting that current investment levels are running well ahead of near-term commercial viability. This disconnect doesn't necessarily imply that AI investments are misguided. Transformational technologies often require years of infrastructure buildout before applications scale. But it does suggest that current valuations embed very optimistic assumptions about both the timeline and magnitude of AI monetization.

Combined AI Capital Expenditure Spending of Major Tech Companies²



Source: First Trust

Recent corporate surveys highlight a substantial gap between AI expectations and results. MIT's Media Lab reviewed 300 corporate AI implementations and found that 95% of pilot projects were failing to deliver expected returns. Multiple disappointing releases of new large language models, including OpenAI's ChatGPT 5.0, Meta's Llama 4, and others, have tempered enthusiasm about near-term capability improvements. These data points don't negate AI's long-term potential, but they do suggest that the path from experimentation to scaled deployment will be longer and more difficult than current valuations imply. Companies generating genuine AI revenues today, not just those investing in AI capabilities, trade at substantial premiums, yet many lack clear paths to profitability at current scale.

Our investment approach in this environment emphasizes three principles. First, we maintain exposure to AI infrastructure providers with diversified revenue bases and proven profitability, avoiding pure-play AI businesses whose valuations depend entirely on future monetization. Second, we favor companies implementing AI to improve their existing operations rather than those attempting to become AI platforms themselves; operational AI adoption tends to generate faster returns with lower execution risk. Third, we remain alert to opportunities among high-quality businesses unfairly penalized for lacking an AI narrative, as market enthusiasm for AI has created pockets of relative value in sectors viewed as "ex-AI." The AI revolution will undoubtedly reshape business and society, but history suggests that most value accrues not to early-stage disruptors but to companies that efficiently deploy mature technologies to strengthen existing competitive advantages. Patient capital willing to separate signal from noise should be rewarded as AI transitions from infrastructure buildout to genuine commercial deployment.

Market Calm Masking Underlying Fragility

One of 2025's most remarkable features has been the disconnect between headline market tranquility and underlying economic and policy uncertainties. The VIX volatility index has settled near 16, below its long-term average, while measures of policy uncertainty have declined from their April peaks. On the surface, markets appear to have achieved a comfortable equilibrium. The Federal Reserve is cutting rates, corporate earnings are growing, and economic recession fears have receded. Yet beneath this calm surface lie several fragilities that warrant defensive positioning: a labor market showing meaningful deterioration,

² Actual and projected capital expenditures from Amazon, Microsoft, Google, Meta, Oracle

tariff policies whose ultimate impact remain uncertain, fiscal dynamics that virtually guarantee elevated deficits regardless of economic conditions, and geopolitical tensions that could resurface without warning.

The labor market presents perhaps the most significant concern obscured by headline data. While the unemployment rate remains relatively low at 4.3%, recent months have seen dramatic downward revisions to previously reported job creation. Preliminary data suggests the economy created 911,000 fewer jobs in the twelve months through March than initially reported, potentially the largest annual revision on record. Monthly job creation has slowed to just 26,800 in recent months, well below the pace needed to absorb new labor force entrants. These dynamics help explain why the Federal Reserve has resumed rate cuts despite inflation remaining above its 2% target, and why the Fed's September statement noted that "downside risks to employment have risen." A weakening labor market could quickly undermine consumer spending resilience, which has been a pillar supporting economic growth despite numerous headwinds.

Tariff uncertainty, while reduced from April's extremes, remains a persistent wildcard. The effective tariff rate above 16% represents the highest level in over a century, creating ongoing cost pressures even as some bilateral agreements have reduced tensions. U.S.-China trade talks remain in their latest 90-day pause, with meaningful resolution uncertain. Perhaps more importantly, recent legal challenges to tariffs imposed under emergency authorities have created questions about the durability of current trade policy. Companies have demonstrated some ability to mitigate tariff impacts through price increases, alternative sourcing, and efficiency improvements, but these adjustments have limits. If tariffs persist or expand, profit margins will eventually face pressure, particularly among companies lacking pricing power or facing intense competition.

The combination of these factors argues for portfolios tilted toward quality and defensiveness. Elevated valuations, concentrated market leadership, uncertain AI monetization timelines, labor market weakness, persistent tariff risks, and fiscal deficits all point toward emphasizing resilience over aggression. This doesn't mean abandoning equities or retreating entirely to cash; rather, it means emphasizing companies with strong balance sheets, proven business models, sustainable competitive advantages, and reasonable valuations. These businesses tend to outperform during periods when market leadership broadens, when economic growth disappoints, or when volatility returns. History shows that quality stocks demonstrate asymmetric return profiles, capturing meaningful upside during continued bull markets while providing crucial downside protection during inevitable corrections.

Our current positioning reflects this defensive tilt while maintaining exposure to secular growth opportunities. We favor businesses with pricing power that can protect margins if inflation reaccelerates or if input costs rise. We emphasize capital-light models that generate strong free cash flow without requiring significant ongoing investment, allowing companies to return cash to shareholders or opportunistically acquire competitors during downturns. We seek management teams with proven track records of disciplined capital allocation, particularly important as the easy gains from financial engineering and multiple expansion fade. These characteristics have historically served investors well during late-cycle environments when market complacency masks underlying fragilities. While we can't predict the timing or catalyst for the next market correction, positioning portfolios for resilience rather than maximum beta exposure seems prudent given current conditions.

In Conclusion

The third quarter demonstrated markets' remarkable ability to rise amid uncertainty, with the S&P 500 reaching new highs despite significant headwinds. Yet elevated valuations, extreme concentration in market leadership, questions about AI investment returns, and underlying economic fragilities all argue for a cautious approach. We remain constructive on equities over the long term, as corporate earnings growth, technological innovation, and American dynamism provide tailwinds for patient investors. However, selectivity and quality focus become increasingly important as the cycle matures.

Our investment approach emphasizes businesses that can thrive across multiple scenarios: companies with pricing power to protect profit margins if inflation reaccelerates, balance sheet strength to invest counter-cyclically if economic conditions deteriorate, and sustainable competitive advantages that allow them to gain market share regardless of macroeconomic conditions. These quality-oriented portfolios may lag during melt-up phases when speculation drives returns, but they provide the resilience and long-term compounding that preserves and grows wealth across full market cycles.

Thank you for your continued trust and partnership. We welcome your questions about current market dynamics, portfolio positioning, or your specific financial objectives. By maintaining discipline, focusing on fundamental value, and avoiding the temptation to chase momentum or narrative-driven speculation, we believe we can deliver attractive risk-adjusted returns regardless of near-term market volatility.

DISCLOSURES:

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

Name of Issuer	% of Equity Portfolio	9/30/2025 Closing Price
Berkshire Hathaway Inc Class B	6.60%	\$502.74
Microsoft Corp	6.34%	\$517.95
Alphabet Inc Class A	6.23%	\$243.10
Apple Inc	5.85%	\$254.63
Bank of America Corp	5.20%	\$51.59
Progressive Corp	4.62%	\$246.95
Jacobs Solutions Inc	3.87%	\$149.86
WR Berkley Corp	3.29%	\$76.62
Dimensional US High Profitability ETF	2.99%	\$37.77
Verisign Inc	2.90%	\$279.57

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.

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