



Dear Valued Investors,

As we bid farewell to 2024, it's once again time to reflect on the dynamic journey we experienced in the stock market this past year.

Last year proved to be a remarkable one for Frontwater investors as the year played out to near perfection. For the second year in a row, average portfolio returns exceeded 20% - even with the US Federal Reserve taking a slow and cautious approach towards interest rate cutting, even with an unconventional presidential election and even with a cooling labour market.

“Forecasts may tell you a great deal about the forecaster; they tell you nothing about the future.”

- **Warren Buffet**

2024 was not originally expected to be a banner year as many stocks had already appreciated substantially in the final quarter of 2023. Some of that momentum was expected to carry over but there was no shortage of economists (including the well known Canadian one) calling for a US recession, if not by Q1 '24, then definitely by the end of 2024.

Yet, no recession materialized; in fact, the opposite happened – US consumer spending shot up; US job payroll numbers stayed strong; and wage growth steadied around 4%. All those “doom and gloom” economic forecasts had once again missed their mark, only to be a reminder that predicting economic outlooks is essentially a fool’s game.

2024 Market Overview

The big story of the stock market in 2024 was the performance of the “Magnificent Seven” as enthusiasm surrounding artificial intelligence propelled tech stocks to significant gains. At the start of 2023, the Mag-7 made up 20 percent of the S&P 500. Today, these seven stocks comprise a weighting closer to 33 percent.

Indeed, ever since our inception over 15 years ago, Frontwater has held the belief that large cap technology stocks should comprise a significant core position of a client’s overall portfolio. Technology continues to be a major source of competitive advantage in nearly every industry. Alphabet, Amazon, Meta, Microsoft, Apple and Nvidia are effectively equivalent to the always reliable Coca Cola stock of the past century.



But technology stocks alone did not drive 2024 performance returns for our Frontwater client base. As clients know, we at Frontwater believe risk mitigation is best delivered by diversifying across industries, sectors and geographies. In 2024, I am pleased to report that Frontwater was able to take advantage of the bullish nature of the market even with a diversified approach that included bank stocks and utilities as part of its core holdings. Frontwater was actually able to outperform the market benchmark but with much less risk.

One sector that we were absolutely bullish on and which we wrote about in last year's annual newsletter was the utilities sector. The utilities and pipelines sector experienced an outstanding turnaround in 2024, rebounding strongly from its poor performance in 2023. At the start of 2024, the sector was trading at its lowest valuation since 1999, at a 15% discount to the S&P 500. Talk about an inefficient market -- many of these low-risk companies were trading with attractive dividend yields in the 5-8% range. The sector flourished as interest rates dropped and investors were drawn to utilities for their stable earnings, consistent dividends, and fundamental strength.

Another sector that we were extremely bullish on was US Financials. In March 2023, Silicon Valley Bank collapsed. At the time, it was understandable as to why investors would shun some of the smaller regional US bank names. On the other hand, why investors would shun PNC Financial, (America's 6th largest bank), or Bank of America (2nd largest) causing the shares to drop 40% was somewhat baffling. Fortunately, we saw this event as a major buy opportunity and loaded up on PNC, Bank of America, JP Morgan, Citigroup, and Schwab. Today, not only have those shares bounced back but US banking is back in vogue with Trump promising deregulation for the financial industry.

2024 Exiting Positions In: BCE, Uber, Adobe

Undoubtedly, we all feel good and smart about ourselves when selecting winners. But it's also important from a performance perspective to minimize exposure to underperforming assets as well as assets whose future profitability is at risk. BCE, Uber and Adobe are three companies that we re-evaluated in 2024 with the notion that it was either time to significantly reduce their positions or exit altogether.

The problem with BCE, not to mention Rogers and Telus, is that the Canadian telecom industry has become ultra-competitive and ultra-regulated with limited upside. Not only is the government forcing companies like BCE to reduce long distance rates, reduce wireless packages, but BCE's legacy of TV and news stations are near worthless as they contend with cord cutting, online streaming, and online news outlets. Layer on BCE's poor management track record, and it's no wonder that this stock was down over 20% in 2024.



Uber and Adobe are slightly different than BCE in that they have much better management teams and they operate in an unregulated industry. Moreover, neither company is showing major weaknesses currently in their business models. That said, when we look out into the horizon and into the future, we see the threat of new competition and it has us worried.

In the case of Uber, our primary concern is Waymo which is the driverless taxi that is 100% owned and operated by Alphabet (Google). This October, I was in San Francisco and had the pleasure of hailing a Waymo. The experience felt like a Disneyland ride in that the car pulled up, the doors automatically open, the drivers seat is completely vacant, and the ride to my destination was as smooth as any other. It was clear that the ‘future’ driverless car was no longer a thing of science fiction. It has arrived.

True, Waymo is currently operating in only four cities LA, San Fran, Dallas, and Miami so it still has a long way to go. It also has yet to figure out the cold weather environment so it may be another 4-5 years before it achieves North American dominance. That said, there can be no doubt that the horses have left the barn. Uber will certainly continue to exist but the threat of Waymo not only changes the pricing dynamics of the industry but completely changes the way the “taxi” industry operates.

Finally, Adobe needs to contend with the threat of Artificial Intelligence. There is a growing fear from investors that the rise of artificial intelligence could really hurt its business model as Adobe specializes in digital media content. With the rise of generative AI, much of Adobe’s service offerings can be duplicated with open-source software simplifying the task of a “creative professional” at a fraction of the price. As with Uber, the major disruption has yet to happen, but the mere threat makes us concerned.

Looking Ahead In 2025

No doubt, Q1 2025 brings with it new challenges and opportunities.

Our natural bias and one of our core beliefs continues to be that well-managed companies will sustain earnings growth and profitability for years and years to come, decades in fact. Obviously, large cap tech companies are living proof of this phenomenon but so too are companies like Costco, Home Depot, Wal Mart, CN Rail, CP Rail, Brookfield Corporation, JP Morgan, John Deere, and so on. In other words, expect us to continue with the “buy and hold” approach with a touch of rebalancing here and there.

In the upcoming year, it is also our expectation that smaller and medium sized firms will likely outperform as the valuation gap between small and large cap stocks has reached historic levels. We expect the big companies to remain profitable in 2025 but it is



important to recognize that the Mag-7 stocks are trading at elevated P/E levels currently around 33 times. Medium sized firms, on the other hand, can be found at more attractive levels typically around 17-18 times.

One sector that grew on us in 2024 was cybersecurity. As more data and information gets stored electronically, there is ever more urgency to protect large businesses from cyber attacks and data breaches. This industry is dominated by two players Palo Alto and CrowdStrike. Buy one or buy both but either way these two companies own that space and explains why we started building positions in these two particular stocks.

On the topic of “discipline”, our performance over the last 5-15 years continues to prove that “staying the course” is the best action plan for long term investing despite all the market’s up, downs, and corrections. Many of our long-term clients now have the experience under their belts to know that owning a diversified basket of high-quality companies is the best survival kit for getting through a recession or pandemic.

While we don’t foresee a recession happening in 2025, there is much debate about the foreseeable future with Trump back in office. Generally speaking though, a Trump administration would be considered stimulative for the economy and beneficial for the stock market. The US financial industry, in particular, should benefit as a result of the incoming Trump administration and its deregulatory policies.

With a continued focus on innovation, sustainable growth, and diversification, we should be able to navigate the evolving landscape with confidence. Likewise, maintaining a “disciplined” approach to portfolio management while staying informed is a key ingredient for successful investing.

Finally, I am very pleased to say that Frontwater is celebrating its 16th year of active wealth management. As always, our team is ready to assist you in navigating the investment landscape while positioning your portfolio for success in the upcoming year.

Wishing you a prosperous and fulfilling 2025!

Regards,

Jeff Kaminker,

President and Founder, Frontwater Capital