WESTBOURNE
INVESTMENT ADVISORS

INVESTMENT PERSPECTIVE — FIRST QUARTER 2025

"The Stock Market has predicted 9 of the past 5 recessions." – Economist Paul Samuelson

2024 has been another strong year for the stock market. The Federal Reserve has successfully executed the "soft landing," keeping the economy robust despite rising interest rates, while inflation has dropped significantly. This combination of solid economic growth and lower rates has been a boon for stocks. Post-election, the market has reacted positively to the prospect of continued lower taxes and less regulation, both of which are seen as favorable for economic growth. However, as history shows, significant market rallies are often followed by corrections. A market decline at some point—whether next week, next month, or in a few years—seems inevitable. We've experienced at least five corrections in the past five years, and when they occur, panic and despair often spark significant market turmoil. We've seen this story before. Let's avoid the trap, stay prepared, and act wisely.

In a past *Investment Perspective*, we explored various pitfalls of investing arising from cognitive biases and emotional factors, e.g., fear and greed, which can lead to irrational decisions. One such behavioral finance pitfall is "Herding Behavior," the tendency of individuals to mimic the actions of others, often ignoring their own analysis or the fundamentals of a particular situation. This behavior is rooted in psychological biases such as *social proof* and *Fear of Missing Out* (FOMO), where investors feel more comfortable following the crowd, believing that others must know something they don't. Herding may be a safe and comforting strategy in the short term, but can lead to bad long-term outcomes as it is not driven by rational thinking and may create asset pricing bubbles and/or market crashes (e.g., the *dotcom* bubble).

Herding Behavior: Herd it from a friend, who, herd it from a friend…(with apologies to REO Speedwagon)

Herding behavior fuels market volatility. When large groups of investors rush in and out of assets, they trigger sharp price swings that don't reflect the market's true fundamentals. This volatility can overwhelm investors, particularly those unprepared for quick shifts in sentiment. As fear and panic spread, the herd often triggers irrational buying or selling, further distorting prices and intensifying instability.

Herding behavior also inflates asset bubbles. As large groups of investors drive up the price of stocks, real estate, or cryptocurrencies, they create a self-fulfilling cycle: rising prices attract more buyers, further inflating the bubble. This detachment from the asset's true value encourages short-term speculation over long-term sustainability. When the bubble bursts, latecomers or those who skipped independent analysis often suffer heavy losses.

Herding behavior is a form of *Groupthink*, where people prioritize consensus and harmony over critical thinking, often misjudging risks and making poor decisions. While following the herd may provide short-term comfort, it usually leads to significant financial losses and missed opportunities for more rational, long-term strategies.

Westbourne's Role – Recognizing the Importance of Equities: In past editions of *Investment Perspectives*, we have highlighted the critical role of equities in building long-term wealth. As *Investment Advisors*, we are committed to helping clients avoid groupthink and stay focused on the long-term,

emphasizing the importance of buying and holding stocks that trade below intrinsic value while maintaining proper asset allocation. To support this approach, we're sharing some key excerpts from an insightful piece by British investor Terry Smith:

"*The Unique Advantage of Equity Investment*" – Terry Smith, Financial Times 4/22/2017

Investment in stocks — equities — has a unique advantage over other asset classes. Equities can compound in value in a way that investments in other asset classes, such as bonds and real estate, cannot. The reason for this is quite simple: companies retain a portion of the profits they generate to reinvest in the business. If you look at companies in the major indices, such as the S&P 500, you will find that on average companies pay out about half of their earnings in dividends. The earnings that are not paid out are invested back into the business. No other asset class provides this. If you own bonds, you receive an interest payment, but it is not automatically reinvested in the bonds. Similarly, if you own real estate, you may receive rental income but none of it will be automatically reinvested in property for you. As well as being a unique feature of equity investment, this can also be a valuable source of compounding in the value of your investments. For example, if you owned the average company in the S&P 500 it earned a return on equity capital employed of 13% last year. If it can retain half the earnings which are attributable to you as an investor and can continue to invest at its current rate of return as its business grows, that half should also earn 13%.

What makes it even more attractive is that on average the companies in the S&P 500 trade at three times book value (valuation), so for every dollar of earnings they retain, they currently create $3 of market value, although of course this — the valuation — can change…It is the reinvestment of retained earnings, not dividends, which provide the majority of the growth in the value of equities. Of course, what is even more attractive is if instead of simply owning the index and seeing the companies reinvest your retained earnings at an average rate of return, you own only companies which can achieve a high return on capital and which can as a result manage to translate each $1 of retained earnings into a market value which is a much higher multiple of book value. If you follow this reasoning, you will conclude that if a company is able to invest retained earnings at a high rate of return, then the last thing you would want it to do is pay you a dividend. This is perhaps best illustrated by Warren Buffett's Berkshire Hathaway, which has not paid a dividend in over half a century.

Stay the Course. ***Roll with the Changes, Keep On Rollin', ooh yeah*** **(more REO Speedwagon)**

We have just witnessed one of the largest two-year gains in S&P 500 history, second only to the rebound following the COVID-19 market crash in March 2020. A significant portion of this growth has been driven by the inflationary environment, where equities have proven to be a reliable hedge against inflation. Our focus remains on identifying stocks we believe are fairly valued, with strong balance sheets and income statements that enable them to generate sustainable shareholder value. Despite recent market gains, we continue to look for opportunities that support long-term growth. Feel free to call us with any questions or visit our offices in Annapolis.

Cheers to a healthy and prosperous 2025,

Scot Labin, CFA - Chief Investment Officer
Joseph C. Wilkinson - Managing Director
David Cunningham - Founder
Jon Levin - IAR, Certified Public Accountant
Bruce Kromminga - Director of Operations