ASB Investment Management

Institutional Portfolio Management Quarterly Review

EQUITY OVERVIEW

Equity markets ended the first quarter of 2026 in what has been, in recent years, a rare state of angst. This was driven by the economic uncertainty resulting from the conflict in the Middle East beginning at the end of February, and the resulting disruption to energy and other commodity markets.

However, optimism that the war would come to a quick conclusion and renewed enthusiasm about the artificial intelligence revolution propelled the S&P 500 to a solid performance in the second quarter, rebounding from a first quarter loss to a 15.2% total return in the second quarter.

In this quarter's iteration of AI exuberance, it was the relatively low-tech, commoditized, and highly cyclical memory industry that benefited the most. Seemingly insatiable demand for memory chips in data centers propelled The Philadelphia Stock Exchange Semiconductor Index to a total return of 156.86%. Idaho based memory chip producer Micron Technology gained an astounding 304.43% in the quarter. The stock's year-over-year total return through the end of the quarter was 836.54%.

Momentum stocks in general were back in vogue with investors in the quarter. The MSCI USA Momentum Factor ETF had a total return of 43.01% in the quarter while the MSCI USA Quality Factor ETF trailed the S&P 500 with a total return of 14.6%.

Adding to investor enthusiasm in the quarter was the actual IPO of Elon Musk's Space Exploration Company in mid-June and the impending IPOs of AI giants Anthropic and OpenAI.

EQUITY OUTLOOK

While we are hopeful that improvements in productivity will result from the massive investments being made in AI infrastructure, we are also concerned that investors are driving valuations of AI related companies to levels that assume massive returns on the capital being devoted to data center and related investments. We are also concerned that investments that were largely funded from operating cash flows are now increasingly being funded by debt and equity issuance.

We think the best approach to projecting future returns is not to be certain of a particular outcome but to think probabilistically about where we place investor money. For example, we think it is likely that most of the gains of the three massive IPOs (SpaceX, Anthropic, and OpenAI) that are expected to enter public markets this year have already been accrued by private market investors. There are companies in the public markets that will likely benefit from using AI tools to improve their operational efficiency but that trade at very modest valuations compared to the marquee names in the AI space that garner most investor attention. We think this is a fruitful way to approach investing in the undeniable advances being made in computing technology.

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INVESTMENT MANAGEMENT

As always, we continue to look for companies with proven profitable business models, reasonable levels of debt, attractive valuations, and good prospects for future growth. We continue to find such opportunities, even in equity markets that are trading at the high end of historical valuations. We also continue to limit portfolio volatility by constructing portfolios with exposure to companies in a wide variety of sectors and industries with limited return correlations.

FIXED INCOME OVERVIEW

Second quarter fixed income returns were low but positive. While short maturity Treasurys outperformed longer maturities, the longer maturity Bloomberg U.S. Aggregate total return of 0.67% beat the Intermediate Aggregate return of 0.47% and the Intermediate Government/Credit return of 0.43% because tighter credit spreads increased the prices of longer-term corporate and mortgage-backed securities. Year-to-date, high quality bond indexes have earned positive returns in the 0.40% to 0.62% range.

As news of a peace framework with Iran progressed the price of West Texas Intermediate oil dropped 33%. Concomitant with the easing of geopolitical tensions, corporate credit spreads tightened 15 basis points to within three basis points of the 71 basis point multi-year low.

Kevin Warsh presided as Chairman of the Fed for the first time at the June 17 FOMC meeting, where the Fed left short rates unchanged for the fourth consecutive meeting. During his press conference Warsh focused much more on inflation than employment. The Fed remains data dependent and is clearly more concerned about reducing inflation than weaker employment and the prospect of recession. Contrary to market sentiment at the beginning of the year when expectations were for an easing of short rates, the market now expects the Fed to hike rates before the end of the year.

FIXED INCOME OUTLOOK

The Fed's post-Great Financial Crisis zero-interest rate policy and balance sheet expansion is likely a major cause of today's inflation. It has resulted in the misallocation of capital leading so many to note today's "K-Shaped Economy" that benefits asset holders at the expense of lower-wage consumers and is a source of the country's widening political divide evident in recent elections.

Kevin Warsh may be the best candidate to head the Fed, but even Superman had his kryptonite. Although it may bring greater volatility to interest rates, we are encouraged by his desire to reduce the Fed's balance sheet. We remind our readers that when Bernanke's Fed first engaged in the large-scale open market purchase of treasury bonds to lower rates and relieve the economic pressures of the 2008-09 Financial Crisis it was considered a "break the glass" moment. Many thought it illegal, and those involved in the decision agreed the tactic should rarely be used.

To his credit, Warsh resigned in protest when the FOMC implemented its second round of quantitative easing. Quantitative easing has since become a regularly used monetary tool, and the Fed continues to purchase bonds even in the strong current economic environment, $300

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billion year-to-date. In addition to capital misallocation and inflation, the Fed's activism has enabled Congress to abdicate its responsibility for managing the country in a fiscally prudent manner. Perhaps we can kick the can down the road for many more years, but if the ruling class waits for a crisis to resolve our nation's debt problem, the ensuing calamity will make all previous downturns look like boom times.

Reflecting on longer term trends, we are reminded of the madness of crowds and what H.L. Mencken said in 1926, "no one in the world, so far as I know... has ever lost money by underestimating the intelligence of the great masses of the plain people." Right now, the masses are pushing the price of everything AI higher.

Recently a financial advisor acquaintance with a long career preceding the internet bubble acknowledged that the market is expensive, and then asked, "but what could make it go down?" Two candidates immediately came to mind: earnings reports failing to meet expectations, particularly at the major tech companies, and the prospect of the Fed hiking interest rates. Bull markets don't die of old age; the Fed has murdered every one of them.

Regarding earnings, record debt issuance from the major tech companies is fueling the boom. The AI builders use the debt to buy chips, which immediately contributes to high-margin earnings for the manufacturers. The capital expense of the chip buyer is depreciated and contributes to earnings over time. As a result, today's record profit margins and increasing earnings may end abruptly with any decline in expectations.

Fixed income returns have so far been uninspiring this year, but lower prices bring higher yields and increased prospective returns. In the current environment, an intermediate maturity investment grade fixed income allocation offers reasonable yields, portfolio diversification, and the opportunity for price appreciation.

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