GDS Investments

Client Note, February 15, 2025

> *"The secret to successful investing is relatively simple: Figure out the value of something and then pay a lot less."*
>
> —Joel Greenblatt, Managing Principal and Co-Chief Investment Officer of Gotham Asset Management

Welcome! It's a new year, a new presidential administration, and a new market environment; and that means it's time for a renewed look at GDS Investments' larger strategy for 2025 and beyond. We need to ensure we can adapt and meet the market where it is today and where it's moving tomorrow.

To start, let's consider where we find ourselves at this moment.

The first weeks of the new Trump Administration have presented us with a whirlwind of Executive Orders and other activity. In this letter, we will be focusing on his statements and activity as it relates to the economy.

Based on his comments at the 2025 World Economic Forum meeting at Davos-Klosters, he seems to simultaneously want:

- Lower oil prices,
- Lower interest rates,
- Lower inflation,
- Lower taxes,
- Higher tariffs, and
- A supply chain more tilted toward domestic production than one rooted in comparative advantage.

Unfortunately, at least some of these things cannot meaningfully coexist, at least not in the short term, e.g., specifically higher tariffs *and* lower inflation seems like a difficult juggling act. Analysis out of the Federal Reserve Bank of Boston® found that "a 25% tariff on Canada and Mexico combined with a 10% tariff in on China could add 0.5 to 0.8 percentage point to core PCE inflation."

We are already seeing impacts; inflation for January rose unexpectedly, culminating in an annual inflation rate of 3% for the 12 months that ended in January. We discussed the inflationary nature of many of President Trump's stated economic priorities in greater detail in our November 2024 client letter, available here.

Consequently, we ultimately believe that the President is going to have a challenging time controlling as many aspects of the economy as he seems to want to.

Indeed, few of the economic items on which President Trump wants to focus are even under his direct control or even under the control of any other single authority. Interest rates, for example, are controlled more by the Federal Reserve. Even there, however, the long end of the rate curve is ultimately more based on the market and how people are thinking about the monetary and fiscal environment. The market will generally pay what it thinks is appropriate for the level of risk it perceives.

Here, indicators suggest the market sees risk rising. As *The New York Times* (NYT) explains here, the term premium on investment vehicles like Treasury bonds is "the amount of interest [that] investors demand over and above where the Federal Reserve sets rates. Recently it's been rising quickly." The NYT speculates, for good reason, that the market is beginning to worry about higher inflation returning and, with it, higher interest rates.

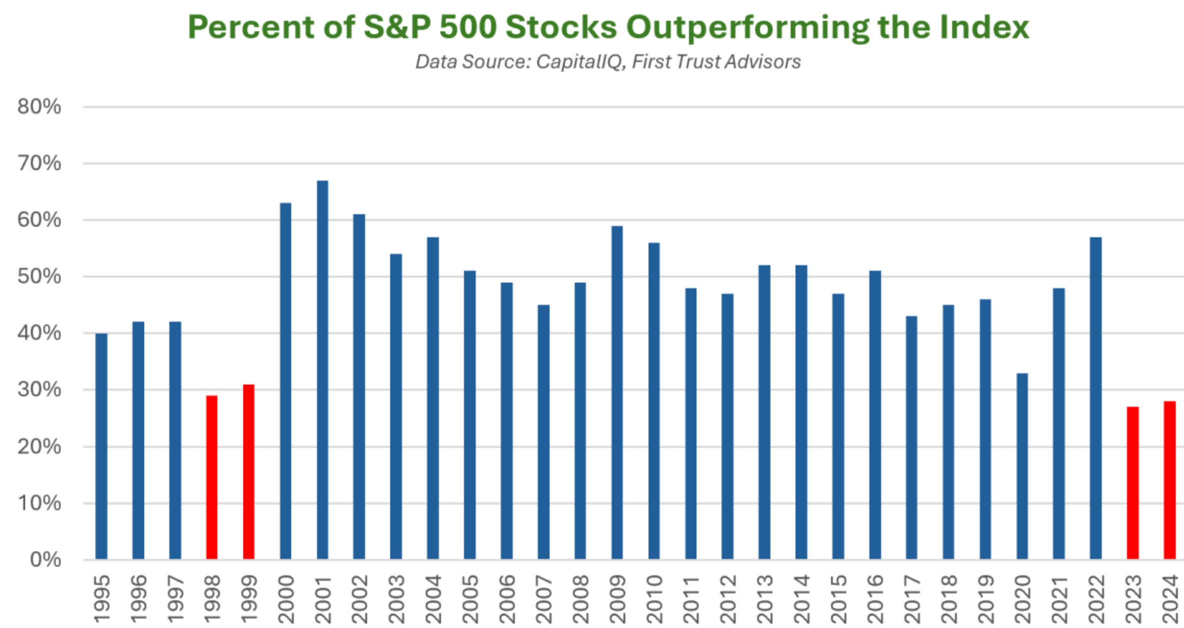
Lastly, one puzzling piece of the Trump Administration's economic vision is the proposed Strategic Bitcoin Reserve. President Trump ordered the creation of a digital asset working group that would investigate potentially creating a stockpile for cryptocurrency, similar to existing reserve stockpiles of gold and oil. The value of such a reserve is not clear to us; and using taxpayer funds to finance this reserve seems inconsistent with the idea of DOGE-driven efficiency, given the lack of inherent utility (unlike, say, oil) and the sheer volatility of cryptocurrency. "It's not clear what a crypto reserve would serve, apart from ensuring there is enough U.S. influence over it," says Padhraic Garvey, regional head of research, Americas at ING.

So, to summarize: a lot has happened since President Trump took office, and we are still digesting much of it. We don't know what's going to work (some policies the Trump Administrative has advanced are clearly supportive of economic growth) and what won't (other policies are, at best, contradictory). Then, to the extent that the Trump Administration is aggressively pushing for more fiscally responsible spending, how are initiatives like the proposed Strategic Bitcoin Reserve consistent with that message?

It is not clear to us how all this evens out in the end. The Trump Administration's economic vision is going to be hard or impossible to implement as described, which creates unpredictability around what will actually happen. Future economic conditions, already notoriously hard to predict, are that much less clear now.

The Market 2025: A Macro View

Looking back on 2024, the indices like the S&P 500 performed well, with a total return around 23%. However, leadership within the indices has narrowed considerably: fewer than a third (31%) of the stocks within the S&P 500 outperformed the index as a whole (see the chart below). This level of leadership is as narrow as we have experienced since the late 1990's. As a result, the broader big cap indices will likely underperform over the next 5-10 years; with outperformance coming from the corners of the market that have been left behind in the most recent leg higher.



Data Source: First Trust Advisors

This brings us to AI. It's likely at least some of the current market environment can be explained by excitement (and straightforward overhype) around AI and similar emerging technologies. It's no coincidence that the current leaders in the S&P 500 are big technology names perceived to be in the middle of the AI ecosystem, including Palantir Technologies (**NSQ: PLTR**), Nvidia (**NSQ: NVDA**), and the FAANG gang—Facebook (now Meta, **NSQ: META**), Apple (**NSQ: AAPL**), Amazon (**NSQ: AMZN**), Netflix (**NSQ: NFLX**), and Google (now Alphabet, **NSQ: GOOGL**).

Plus, note from the chart above how the last time leadership was this concentrated was during the 1997-2000 dot-com bubble. In fact, some economists are already explicitly comparing AI to the that bubble. We decline to make a firm prediction here, but it's admittedly difficult to understand where the profits are going to be for the companies building AI models and tools, especially as lower-cost alternatives like DeepSeek are already beginning to disrupt the field. There is a real possibility of some piece of the AI landscape becoming commoditized, e.g., users can go to *any* AI tool, type in a question, and get output of roughly similar quality. Price then becomes the main or even sole differentiator. A commoditized product offering likely cannot support the level of investment and valuation currently pouring into the market.

We also note that some credible technology analysts are beginning to hedge their excitement, especially around generative AI (Gen AI). Advisory group Forrester, for example, has cautioned that they expect enthusiasm in Gen AI to slow as the business case for it falters "due to lack of quantifiable value." Similarly, analysts at Gartner expect nearly a third of Gen AI projects to be abandoned by the end of this year. "After last year's hype, executives are impatient to see returns on

GenAI Investments, yet organizations are struggling to prove and realize value," says Rita Sallam, VP Analyst at Gartner.

There are certainly exceptions, but these exceptions will manifest only when AI is explicitly serving a clear business case in a targeted way. Here, we might cite Amazon, one of our longstanding positions. Andy Jassy, the CEO of Amazon, mentioned at his AWS re:Invent 2024 keynote address that he expects warehouse costs to fall substantially thanks to AI.

Specifically, an AI-driven pilot test ("Sparrow") enabled a 25% improvement in processing times at warehouse fulfillment centers by speeding up item sorting and optimizing item placement. Elsewhere, Amazon has seen evidence that AI models can improve inventory accuracy by up to 10% and even boost customer satisfaction scores. "AI represents, for sure, the biggest opportunity since cloud, and probably the biggest technology shift and opportunity in business since the internet," Jassy says.

Tying AI to a clear cost savings-focused use-case is reassuring. When companies can point to clear margin expansion and the associated margin dollars that will come out of their cost structure, it becomes easier to have confidence in AI as a legitimate business-booster. And Amazon's focus on cost containment has historically worked well for the company. In 2024, for example, Amazon's total revenue increased nearly twice as fast as its operating expenses (11% to 6%). AI could herald even greater savings; a Morgan Stanely report estimates that a 25% reduction in fulfillment costs could lead to $4.5 billion to $9 billion in annual savings through 2030.

On the other hand, for companies leveraged to the demand side (i.e., their growth and success depends on continuously increasing demand for AI), it's hard to see how AI shakes out. The Stargate Project—a plan to invest $500 billion over the next four years in AI infrastructure in the U.S.—is the latest example. We have relatively less confidence in and/or familiarity with the players involved in that effort (including Oracle, OpenAI, and SoftBank). Rather than taking a mature company with a huge, well-established moat, like Amazon or Google, and using AI surgically to make what they do more efficient, creating value from scratch around AI is a much less certain proposition, especially if AI tools do become somewhat or entirely commoditized.

Investing 2025 and Beyond: The Micro-Level View at GDS Investments

To understand our take and reaction to this market and political/economic environment, it may be helpful to reiterate our foundational view of value investing. The GDS Investments philosophy is to invest in foundationally strong companies which are well-positioned for long-term growth and then hold them for a long time. We continue to subscribe to a straightforward value investing philosophy of buying quality assets at a sizable discount relative to fair value and patiently waiting for this discount to narrow over time.

To that end, we are continuing to hold onto our relatively new position in Nike. We wrote in more detail about the appeal of Nike Inc. (**NYQ: NKE**) in our October 2024 letter, and if anything, we are even more encouraged. Nike offers a classic example of a fundamentally strong company riding through a rough patch, causing the market to unfairly discount its value.

Admittedly, Nike is not facing an easy fix. Nike's poor handling of the distribution side of its business over the last few years was a genuine mistake. They cut off ties with retailers because they (under previous leadership) felt they could build their online business (Nike Direct) and simply cut out the middleman. Initially, this effort seemed to yield promising results. However, over time, reduced physical availability made it harder for people to buy its products, and it began to lose brand relevance as it lost shelf space to competitors; hence the market devaluing the stock.

Nike is under new leadership now: newly installed CEO Elliott Hill, a former insider has already begun a series of initiatives designed to restore Nike's prominence in stores, leveraging his pre-existing relationships. He's trying to restore Nike's culture (he has vowed to "put sport back at the center of everything we do"), rebuild relationships with both retailers and stewards of the brand, and put more emphasis on groundbreaking product development.

On that last point, John Hoke, Nike's chief of innovation, has said he is focused on apparel and footwear that "will blow athletes' minds and shock the world of sports." He cites the example of active wear that can, for example, adjust to whether the wearer is running up- or downhill. We were already confident in Nike's ability to outperform its current pricing, this newfound focus on rebuilding relationships and restoring Nike's old culture (the one that once made it the dominant market leader worldwide) has given us even more enthusiasm for the position.

Similarly, we remain reluctant to trim two key anchors—Google/Alphabet and Amazon—that did well last year. Alphabet's stock values increased by around 42% over the course of 2024, and Amazon's by over 50%; and both have essentially doubled since their late-2022 lows. We were able to enter those positions at an advantageous time when the market was unduly discounting them. Today, they offer a long runway with a strong reinvestment ability to not only grow more entrenched with existing customers but also capture emerging business. So, we still own them with confidence.

However, many of the other biggest names in the market right now are less attractive. Remember, it's hard to make money even from exceptional companies if we cannot acquire them at a discount. Given how stretched valuations have grown at the top of the market, we have been looking elsewhere for newly emerging opportunities.

Here, we've been drawn toward a series of more cyclical companies in the early stages of emerging from a more favorable supply environment , specifically in the offshore drilling space. In particular, Tidewater (**NYQ: TDW**), Valaris (**NYQ: VAL**), and Schlumberger NV (**NYQ: SLB**) stand out. These companies have qualities that we like. The stocks are cheap, balance sheets are strong, and the supply backdrop is becoming more favorable with fewer operating rigs in the marketplace, and significantly less competitive pressure from fracking, etc. than the start of the previous cycle. Tidewater and Valaris have fallen to around half of their 5-year stock price highs (TDW: $53 now vs. $107 at its high, VAL: $45 vs. $80). Even Schlumberger has fallen by a third ($42 vs. $61) while the global fleet of offshore rigs has almost halved over the last decade (to roughly 150 today). The restricted supply should result in higher day rates and higher margins as old contracts re-price in the coming years. Of note is the long lead times to bring on additional capacity in this industry (3 years for the average new vessel), which means that today's current tight supply will last for the foreseeable future.

We are particularly encouraged by managements aggressive tilt toward shareholder-friendly policies and the fact that numerous industry "insiders" we trust, like investor John Frederiksen and investment management company Lingotto, have put equity capital into this industry in recent quarters.

Another new position of interest: Sirius XM Holdings Inc (**NSQ: SIRI**).

Over the past year, Liberty Media (NSQ: LLYVA), under billionaire John Malone, merged Liberty Sirius XM with Sirius XM Inc. and spun it off into a new independent asset, Sirius XM Holdings Inc. In the process, they simplified the equity structure, so instead of having the equity owned by two distinct public companies, it's now a single company under the SIRI ticker symbol. Berkshire Hathaway (**NYQ: BRK.A**) has since become a major shareholder, now owning 35% of the company through 117.5 million shares as of the last 13F filing (Berkshire has purchased additional shares after 12.31.2024).

Its underlying metrics suggest this is unfairly discounting the business. For one thing, it has over 33 million subscribers as of the end of 2024 and closed a deal last year with auto manufacturers like Tesla and Rivian to offer the new SiriusXM 360L service in select models to further expand its installed base. True, growth in subscriptions has plateaued over recent years, but subscriber churn is impressively low (1.6%). For context, this churn rate is better than both Spotify (2.0%) and Netflix (1.8%) and, though they're not direct competitors, *far* better than other subscription services like Hulu (15%) or Paramount+ (24%).

What we see is a strong subscription-based business with a 50-60% gross margin and historically a 25-30% EBITDA margin. The market seems overly reactive to revenues flattening but under-appreciative of its sheer stability and attractiveness of its subscription-based model.

They are also consolidating their market position by launching a new operating platform (the aforementioned SiriusXM 360L service) that will allow them to gain insights into consumer behavior that were not previously accessible. This will enable both new monetization opportunities and also new capabilities for attracting and retaining new subscribers through a more personalized offering. This may also offer them the first chance to really capitalize on their acquisition of Pandora in 2019, perhaps by developing new advertising packages. In short, with a healthy installed base, stable subscription rates, and a more robust platform offering more options for monetization, Sirius XM offers an attractive formula for success.

Even better, with Ted Weschler via Berkshire Hathaway involved, we suspect investors will see discipline in terms of capital allocation as well. Notably, Weschler has done this before to great success for firms like retailer Dillard's (**NYQ: DDS**); even facing an entire industry in terminal decline (with over a thousand malls closing every year between 2017 and 2022), Dillard's stock value is at an all-time high right now ($486 per share) and has been on a steady rise since the pandemic. In short, Weschler and Berkshire Hathaway have experience with creating enormous shareholder value through sensible capital allocation.

For Sirius XM, we're looking for shareholder yields (debt paydown + share repurchases + dividends) that exceed 15% at the current market cap and free cash flow. The company's own stated capital allocation focus prioritizes "deleveraging in the near-term while simultaneously enhancing stockholder returns." They are looking to reduce debt by around $700M in 2025, return a quarterly dividend of $0.27 per share, and continue a $1.2 billion common stock buyback program. To put this in perspective, SIRI's current market capitalization is $9 billion.

Into the Future

As described above, we clearly see under-the-radar opportunities with the top-heavy levels of concentration happening in the market. Not dissimilar to the late 1990's, the S&P 500 is at a vulnerable time with how it is structured. When we have periods when the big get bigger (also referred to as "momentum"), especially in terms of the billion- or trillion-dollar companies at the top of the S&P 500, the environment is going to grow increasingly fragile because so much money is tied up in so few (and overvalued) assets. There's an element of a "reversion to the mean" here. The environment has gotten stretched, and the risk of a snapback to something more typical, like a 2000-style correction after the dot-com bubble, is not insignificant. The good news: excessive optimism in some areas will almost always be matched by excessive pessimism in others. I feel strongly that our contrarian positioning today will be rewarded over time.

If you would like further insight into our thought process around these and other assets, we invite you to listen to our recent "Best Ideas 2025" conversation with John Mihaljevic, a Managing Editor of *The Manual of the Ideas*, available here or anywhere podcasts are found.

Annual ADV Offering:

ADV Part 2 has been updated as part of our annual update amendment. Material changes since the previous annual update include:

- Item 4e: Updated assets under management.

You may request an updated ADV Part 2 brochure by responding to this email or calling my mobile (484.888.9155).

With warm regards,

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