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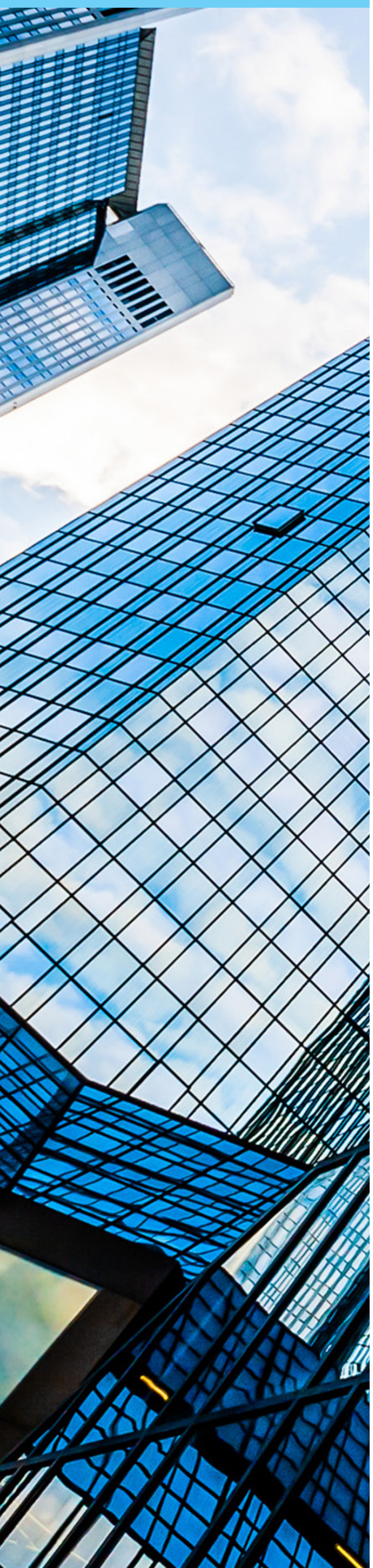

2025 ANNUAL INVESTMENT LETTER

Diversification in the Face of FOMO: Staying Home While the Party Goes On

By NEPC Research

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The FOMO is real.

As an investor, the regret of a diversified investment philosophy as markets soar is a heavy burden to bear. It is only understandable that those wishing they had stayed longer at the exuberant U.S. stock market party of the last two years are tempted to follow the festivities in 2025, potentially at the cost of diversification.

At NEPC, we acknowledge the allure for investors to pursue outsized returns, and the desire to double down on what's worked in the recent past. But as guardians of your wealth and capital, we also recognize the vagaries of the investment world: a strategy works…until it doesn't, a market is on a tear…until it isn't, and the exits can get pretty crowded when the music stops. That is why we advocate an investment philosophy that will withstand the ending of many a party, while also benefitting from the beginning of new ones. Our emphasis on diversification could lead you to miss the end of the party, but it could also mean you didn't get stuck when it was over.

As we begin 2025, we see the potential for substantial change in the world…with results that could be both disappointing and rewarding for investors. On the heels of a blockbuster 2024, where U.S. equities delivered returns of over 20% (for the second straight year) led by the so-called Magnificent 7 stocks (for the second straight year), inexpensive investment opportunities with significant upside are hard to come by.

We acknowledge the allure for investors to pursue outsized returns, and the desire to double down on what's worked in the recent past.

As we view the current investment landscape through the lens our four market themes—pockets of euphoria, the massive spending on artificial intelligence, the return of tariffs, and the current state of world affairs—we advocate investors embrace risk, but not chase returns. In the absence of cheaply priced investments, this could be the year to look inwards and stay close to strategic targets, review investment policy benchmarks, and lean towards simplicity. At NEPC, we stand ready, as always, to help you stay the course and remain disciplined…especially when it feels hard.

Below, we examine our key themes and how they will likely shape investment opportunities and performance over the course of 2025. We see the potential for an extraordinary level of volatility associated with these themes and expect they will meaningfully impact market dynamics this year.

POCKETS OF EUPHORIA

While U.S. markets broadly do not appear to be in a bubble like the late 1990s, we see inflated valuations in several market segments, especially in cryptocurrency with the price of Bitcoin hovering around $100,000 and the market capitalization of all crypto totaling over $3.5 trillion. While cryptocurrency clearly mirrors the mania associated with past bubbles (tulip bulbs, anyone?), its link to the broader financial system and market sentiment is opaque and the impact is unclear should a collapse occur. To a lesser degree, we also see exuberance in the Magnificent 7 and AI stocks of the S&P 500. The result of the euphoria is a narrow concentration in the top exposures of the S&P 500, but it is fair to say their financial profile is a far cry from the extreme valuations of the dot-com bubble.

ARTIFICIAL INTELLIGENCE SPENDING

Faith in AI adoption has propelled U.S. equities to great highs, but it also leaves the market exposed to any reversal in sentiment. (Exhibit A: the sharp drawdown in Nvidia and AI names following DeepSeek's announcement regarding the capabilities of its cost-efficient AI models.) We believe the expanding capital expenditure on AI from the largest names in the S&P 500 will have an outsized impact on market sentiment over the course of the year. While there is no question that data centers are the engines for artificial intelligence, we need to see sizable productivity gains to capture the return on investment associated with AI spending to support the lofty status of the Magnificent 7 and AI stocks of the S&P 500.

TARIFFS EXPLAINED

Part of an ongoing trend for many years now, globalization has fallen out of favor and the past economic world order cannot be relied on to provide market stability. The key question likely to be asked this year is whether the tariffs announced by the new administration are economic policies to be executed or a tool to negotiate with. In addition, the fine print will also matter around how tariffs are carried out, their scope, timeline, exemptions, and retaliatory actions from the affected countries. That said, we believe the economic implications of tariffs are likely to be muted in 2025, but an escalation that restricts the flow of goods poses a larger market risk.

WORLD AFFAIRS

Markets and investor sentiment in 2025 will be intently focused on geopolitics and the policies of new governments taking office. Key questions will include how a shift to more protectionist policies will impact inflation and growth, within and outside the U.S. Also under scrutiny: China and its role in the global economic order as the world's second largest economy wrestles with internal economic challenges, while dealing with trade and geopolitical tensions with the U.S. Collectively, the potential for market disruption has tempered our view of non-U.S. equities. That said, we stand by our emphasis on remaining balanced and diversified as market sensitivity to geopolitical events can be acute, but is often short lived. Over time, markets tend to shrug off geopolitical conflict and we encourage investors to lean into volatility amid market drawdowns and rebalance to strategic portfolio targets.

CURRENT INVESTMENT OPPORTUNITIES

While our market themes inform many of the key trends we are likely to see in 2025, we assess investment opportunities on the basis of fundamentals, market sentiment and risk management. Overall, we are cautiously optimistic on equities across public and private markets.

In the U.S., we do not see a bubble for the S&P 500 at this time despite the bullish investor sentiment in public stocks. That said, the top 10 holdings of the S&P 500 have posted outsized results and helped the index deliver back-to-back gains of 20% in 2023 and 2024, a first since the late 1990s. The top 10 names now account for over 35% of the S&P 500, which is one of the most concentrated markets we have seen since Japanese equities relative to international stocks in the late 1980s. As a result, while the S&P 500 and U.S. equities remain a mainstay in portfolios, we encourage investors to complement this holding with value and quality exposures to reduce concentration risk and produce a more balanced U.S. large-cap position.

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Outside of the U.S., we continue to believe global equity strategies offer a compelling alpha opportunity and we recommend greater use of active approaches. Furthermore, volatility may be beneficial for global equity as active managers can more efficiently exploit dislocations across markets with tactical allocation shifts.

Meanwhile, in private markets, we suggest investors remain disciplined and stick to long-term pacing plan schedules. Within private equity, we are constructive on value investing in buyouts, while also looking to opportunities in the lower middle-market segment. Separately, in private real assets, we see significant growth in spending on digital infrastructure, and we continue to favor digital infrastructure and energy transitions strategies. Overall, we encourage investors to be liquidity providers and re-up with proven managers.

Across fixed income, we see interest rates at normalized levels, differentiated from the low rates and easy monetary policy of the past decade. Broadly, credit is still relatively attractive on a risk-return basis; however, we are shying away from high-yield corporate debt as credit spreads hover near cyclical lows and offer limited value. In addition, we recommend introducing a dedicated exposure to U.S. TIPS to strategic policy targets due to attractive real interest rates and the potential benefit from an inflation surprise. It is important to highlight one of the core functions of fixed income in a portfolio: to offer liquidity and mitigate portfolio drawdowns in periods of market stress. To this end, we remain comfortable holding excess portfolio liquidity and maintaining neutral duration targets relative to safe-haven fixed income.

From a strategic asset allocation perspective, we believe it is critical to look for diversification opportunities across the portfolio. Diversification will be rewarded over time as we see a greater range of outcomes across capital markets. At NEPC, we are trained to avoid the temptation of doubling down on the best performing asset, and to apportion assets across a portfolio to support a wide range of critical risk functions, including stability during a crisis. While the FOMO may persist in 2025, we are confident that diversification will help portfolios withstand the test of time and weather market stress whenever the music stops and the party ends.

IMPORTANT DISCLOSURES

Past performance is no guarantee of future results.

All investments carry some level of risk. Diversification and other asset allocation techniques do not ensure profit or protect against losses.

This memo should not be considered customized investment advice. Please contact NEPC for advice specific to your investment program.

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