Wespath

Investment Services Driven by Your Mission

A Message from Chief Investment Officer

Johara Farhadieh

Happy New Year! I hope your holidays have been filled with blessings and family time.

2024 was a remarkable year. It was my first full year at Wespath[1] and marked my first several months as CIO. We welcomed two new members to our investment team and grew the number of mission-driven organizations we support. We launched two new investment funds in the I Series. And since I began as CIO on August 1, our team has conducted over 45 due diligence meetings with current asset managers and held more than 50 meetings with new prospective managers.

2024 also challenged us in many ways. We faced the uncertainties of a U.S. presidential election, persistent inflation, conflict around the world and more. Higher interest rates and regulatory constraints have led to much less activity around mergers and acquisitions. The dominance of several mega-cap tech companies continued, raising questions about diversification and valuations.

Our focus now shifts to the opportunities ahead in 2025 and beyond. For investors, the widening disconnect between small-cap company valuations and underlying fundamentals may present opportunities for those looking to take a contrarian stance. Here at Wespath, we've set new goals and begun important work that I'm confident will continue to deliver value to our clients in the future.

You'll hear more about 2024's successes and challenges in this quarter's letter. We'll also share a bit more about what we're looking forward to as we head further into the New Year. Wishing you a healthy, joyful and prosperous start to 2025. May the year ahead bring continued success!

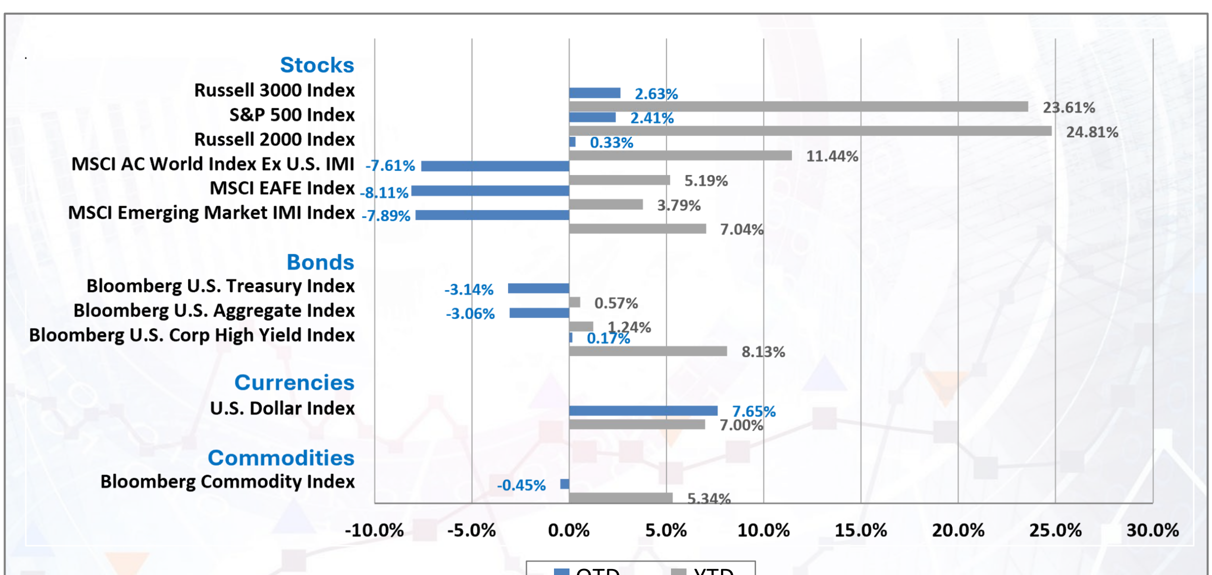
[1] *This letter is intended for institutional investor audiences. Wespath Benefits and Investments ("Wespath") is a general agency of The United Methodist Church, a 501(c)(3) tax-exempt organization. Wespath administers benefit plans and together with its subsidiaries, UMC Benefit Board, Inc. ("UMCBB") and Wespath Institutional Investments, LLC ("WII"), invests (or provides back-office services for) assets on behalf of benefit plan participants and beneficiaries, plan sponsors and other institutions controlled by, associated with or related to The United Methodist Church. The P Series funds are managed by UMCBB, and the I Series funds are managed by WII. As part of the Wespath organization, the WII and UMCBB utilize certain shared personnel, including investment professionals. The shared personnel relationship is governed by the terms of a Dual Employee Agreement entered into by and among Wespath, WII and UMCBB.*

Wespath Quarterly Investor Letter

Mission • Impact • Performance

Key Takeaways from Q4

- **GDP**—U.S. GDP growth for the fourth quarter is estimated at 3.1%, per the U.S. Federal Reserve (Fed) Bank of Atlanta's GDPNow forecast. Full-year GDP growth is expected to be 2.7%. This is slightly stronger than the 2.5% growth seen in 2023.
- **Inflation**—U.S. inflation is leveling out, with the Consumer Price Index (CPI) rising 2.7% year over year in November, in line with expectations and modestly higher than the 2.5% rate recorded in August.
- **Jobs**—The unemployment rate in the U.S. remained relatively stable at 4.2% for November. However, this rate is higher than a year ago; in November 2023, the unemployment rate was 3.7%.
- **The Fed**—On December 18, the Federal Reserve (Fed) cut its benchmark rate by 25 basis points to 4.25% – 4.50%. This was the third consecutive rate cut, but the Fed's post-meeting statement indicated a more balanced view. Futures markets are now pricing in just two cuts of 25 basis points in 2025.
- **Stocks**—The S&P 500 gained 2.4% for the quarter and 24.8% for 2024. In international stock markets, the MSCI ACWI ex-U.S. IMI fell 7.6% and the MSCI Emerging Market IMI Index dropped 7.9% in Q4.
- **Bonds**—Yields spiked in Q4, with the U.S. 10-year yield bottoming near 3.65% in September and pushing higher to end the year near 4.57%. The yield curve has risen on expectations of stronger U.S. growth and inflation in 2025.
- **U.S. Elections**—Donald Trump won the U.S. presidential race on November 5. The Republicans took back the Senate with a 53 – 47 majority and retained control of the House, 220 – 215. Markets are closely watching for regulatory changes that may impact inflation and growth, such as news tariffs and immigration policies.
- **At Wespath**—We welcomed Virgilio Calahong, CAIA as our new Manager of Public Equities in November and launched the Social Values Choice Equity Fund – I Series (SVCEF-I) and the Social Values Choice Bond Fund – I Series (SVCBF-I) in December.



As of December 31, 2024

Beyond the Headlines

U.S. Elections Dominate Investor Attention

The markets were squarely focused on the U.S. elections heading into and throughout Q4. Donald Trump's reelection and the GOP's stronger-than-anticipated performance in Congressional races have resulted in mixed action from the markets since Election Day. U.S. stocks have continued to grind higher and international stocks have moved lower, while volatility continued in the U.S. yield curve and medium-to-long-term rates jumped sharply higher.

The Republican win raises new questions about federal policy. So far, investors have focused mostly on any tariffs and/or changes to immigration policies that might impact economic growth. Also of note: Congress extended the federal budget just before year-end through March 15, 2025, and another debt ceiling showdown. Investors are looking for signs on how much of the recent political rhetoric is real—and how much might be fodder for negotiations. The lack of clarity suggests an uncertain start to 2025.

"Magnificent 7" Continue to Lead, National Deficit Continues to Grow

U.S. small-cap stocks rallied in the wake of the election, in part because they were the winning asset class after the 2016 election—but also thanks to expectations of deregulation and tariffs that may favor smaller companies. However, as yields continued to rise in December and the Fed signaled fewer rate cuts in 2025, the broad U.S. market pared gains and small caps closed the quarter behind large caps. The "Magnificent 7" stocks (Apple, Amazon, Alphabet, Meta, Tesla, Microsoft and Nvidia) once again outperformed the broad market in Q4, gaining 20%, fueled by Tesla's gains of more than 50%.

International stocks fell on the quarter as the macro background for international markets remains soft. Economic growth is weak around the globe, and international earnings are growing slower than in the tech-heavy indexes of the United States. This sluggishness was exacerbated following the U.S. elections in November, as investors continue to evaluate how much of the tariff talk is meant for negotiating versus real policy that could impact international companies.

Observers could argue that a major factor driving the current "U.S. exceptionalism" is our fiscal deficit of an eye-watering 6.2% of GDP. In Q4, the Congressional Budget Office reported an 8% increase in the deficit for the fiscal year ended September 30, 2024, bringing the total national debt close to $36 trillion. As the U.S. continues to grow its deficits, the need for U.S. Treasury debt issuance also grows, which helps explain some of the rise in yields.

Still, even as yields have risen, credit spreads on corporate and high-yield bonds remain near all-time lows. This implies continued confidence in the strength of the economy and low concerns about defaults. Amid very-low spreads, bonds' total yield-to-worst—a popular valuation metric for bonds which measures the lowest possible yield for a bond held to maturity without default—likely remains attractive for investors concerned about the expensive valuations of certain equities.

Insights from the Wespath Team

Under the Hood of Our Investment Process

The recent launch of SVCEF-I and SVCBF-I provides a great opportunity to highlight our investment process and approach to building commingled investment funds. Our investment process can be thought of as three phases: fund construction, manager selection and ongoing monitoring. Each of these phases is crucial in ensuring we deliver “investment excellence” to the investors in our funds.

FUND CONSTRUCTION

The first step in fund construction is determining the fund’s objective, or what investment outcome we’d like it to achieve. From there we consider asset allocation. For single-asset-class funds like SVCEF-I and SVCBF-I, that means thinking about reasonable ranges of exposure to sub-asset-classes like U.S., international, small-cap, large-cap and so on. We then consider overall strategy—whether active management, passive management or a blend of both is most appropriate to achieve the fund’s objective.

The focus then shifts to diversification and risk management. We seek to ensure our funds are well diversified, that any underlying strategies are complementary rather than redundant, and that each fund is built to seek value in various market environments. We also consider how diversification can mitigate risks, while seeking to determine an appropriate risk budget for each fund and implementing guardrails and rebalancing strategies to avoid the risks of potential unintended biases. There is no “one size fits all” approach to fund construction—the factors driving the specific decisions we make in this phase will vary based on the fund’s objective.

MANAGER SELECTION

Once we have a good understanding of what we’d like a fund to look like, we move to manager selection. Our asset managers make the buy, sell and hold decisions on the securities within our funds, so it’s critical we get this step right and hire world-class firms.

We source potential managers through our existing relationships, our professional networks, conferences and events, and industry databases. We seek to employ an inclusive approach—one which includes new and boutique firms, women- and minority-owned firms, and other top-tier asset managers.

The manager evaluation process typically includes desk research, introductory meetings and, in the final stages, on-site due diligence visits. We consider numerous factors to assess managers’ core competencies, investment teams, organizational strengths, investment processes and performance histories.

The final step in manager selection is a formal recommendation to our internal Investment Committee, which is chaired by CIO Johara Farhadieh and features members of our Investment Management, Sustainable Investment Strategies and Institutional Investment Services teams. This is a deeply collaborative process involving diverse perspectives to help ensure we get a complete picture of the asset managers under consideration.

Under the Hood of Our Investment Process (continued)

ONGOING MONITORING

Once we launch a fund or integrate a new manager within an existing fund, we move to a monitoring phase—which never ends!

We monitor our funds every day to ensure they're operating smoothly and efficiently. Over longer time horizons, we're monitoring whether each fund is meeting its objective and how its performance stacks up to its benchmark and peer universe. We keep a close eye on those risks and unintended biases described in Phase #1—and whether each manager is living up to the conviction we identified in Phase #2. We seek to meet with all managers at least quarterly and send them a detailed firm- and strategy-level questionnaire at least annually. We also regularly visit managers at their offices or host them in our Wespath offices for in-depth due diligence conversations.

More About the Social Values Choice Funds

SVCEF-I and SVCBF-I are designed for institutional investors that want to exclude fossil fuel companies and certain securities associated with conflict-affected areas from their portfolios. The launch of the Social Values Choice (SVC) funds in the I Series represents an expansion of the SVC funds, which have been offered by Wespath to participants and plan sponsors through the P Series funds since 2017.

The funds are both single-asset-class funds managed by one subadvisor each. Our manager selection process resulted in the selection of two managers: for SVCEF-I, Xponance; and for SVCBF-I, PIMCO. PIMCO has served as the subadvisor for the Social Values Choice Bond Fund – P Series since its inception in 2017. Xponance is a new asset manager partner for Wespath and will serve as the subadvisor to both SVCEF-I and SVCEF-P. Xponance is a woman-led, 100% employee-owned firm.

Please read more about the SVC funds in our recent announcement!

Looking ahead

Heading into 2025, Wespath and other investors will continue to watch for signs that the U.S. economy is robust and that inflation is contained under 3%. But perhaps even more than growth and inflation, we may expect a heightened focus this year on earnings. Can U.S. companies continue to deliver earnings growth at a double-digit pace? And will U.S. earnings growth continue to outpace those of international markets?

Notably, earnings for small- and mid-cap companies are currently estimated to grow faster than the Magnificent 7 in 2025, which would reverse the trend of the past two years. And at the same time, U.S. small caps are the cheapest they've been in terms of price-to-earnings relative to large caps in about two decades.

As for whether the U.S. exceptionalism theme is likely to continue, investors may need to see another catalyst or two for a reversal. The U.S. remains the world's dominant growth engine for both GDP and earnings. We're not seeing any immediate indications of lower deficit spending to come, and U.S. companies will likely continue to benefit from the AI trend. Plus, a strong U.S. dollar and "higher for longer" U.S. interest rates could add additional headwinds for international markets since investors can earn relatively high interest rates in a stable currency.

Of course, U.S. outperformance will not last forever. Perhaps the trend reversal will be triggered by softer-than-expected earnings results, especially from the Magnificent 7. We know that markets climb a "wall of worry," and satisfying earnings expectations will be a theme on that wall this year. Some others that could impact both U.S. and international results include:

- Tightening of liquidity
- An unexpected sharp uptick in inflation leading to interest rate hikes
- The implementation of higher tariffs, leading to slower growth and higher inflation
- Continued turbulence in G20 governments, leading to political uncertainty and the continued rise of populism globally
- Escalations of the wars in Ukraine and the Middle East
- Further economic weakness in China, dragging global growth lower
- Widening of credit spreads off near-record lows

And many more unknowns and uncertainties. But remember: We're constantly climbing this wall. A long list of potential risks at the beginning of a new year is neither unprecedented nor an endorsement of a particular strategy. As we've written many times before, our investment approach is intentional about taking a long-term view and weathering these types of near-term question marks. Truly patient investing means aligning our strategies with a focus on intrinsic value rather than popularity contests or short-term trends.

As an organization, we're excited for another year of growth and opportunity. We're focused on deepening our relationships with the clients we support, while also building new relationships and connections. And as always, we'll be seeking to do so while continuing to deliver the exceptional service and tailored solutions you've come to expect. We look forward to the progress we'll make together!