Morgan Stanley

Philip W. McCauley III, CFA®
The Madison Group
Managing Director, Wealth Management
Senior Portfolio Management Director
Financial Advisor

Wealth Management
4969 US Highway 42
Suite 1200
Louisville, KY 40222

direct 502 394 4034
fax 502 434 6467
toll free 800 626 1592

NMLS # 1255533
philip.mccauley@morganstanley.com

Nothing ever becomes real
till it is experienced.
- John Keats

I have been investing real money for real people in the real world for 34 years. Through good times and bad. Economic booms and busts, speculative bubbles and market panics and just about everything in between. Through the years I have developed core beliefs. They are pretty straightforward and simple, but not simplistic. One of these beliefs is that there are two kinds of simple. One comes from naiveté, which fuels false confidence and sloppy decision making. The other emerges through experience and serves as guiding light when making decisions that involve many variables and much uncertainty. I am sharing my beliefs so that clients can better understand who we are and what drives our investment decisions. I'm not interested in selling people on these ideas. People either get it, or they don't. I am not suggesting our way is the only path to success, that would be silly, it is just the best way I know.

Money makes money.
And the money that money makes,
makes money.
- Benjamin Franklin

I believe progress is inherent in the human race and inflation is inherent in the financial system. Investing is essentially about letting both progress and inflation work for you. It is a lot more challenging than it sounds. Most investments underperform. Walmart's success led to the failure of thousands of small retailers. Amazon crushed even more. Google's advertising business dominates while countless newspapers fade away. Real estate values in wealthy enclaves soar while prices in thousands of rural towns fail to keep up with inflation. Progress tends to create compounding advantages for a few big winners, leaving all the rest to fight an uphill battle. The same goes for inflation. Most businesses see costs rise faster than revenue, while a fortunate few can leverage scale and technology to expand their competitive advantage.

Doubt is an uncomfortable condition,
but certainty is absurd.
- Voltaire

To succeed, I believe investors must deal with the fact that the world is unpredictable, and most investments only do okay (or worse). In my experience, this reality means investors need to track key business drivers and operating metrics, limit losses on what does not work out and let the few big winners drive portfolio performance. Investing is like other important pursuits in life. Not as complicated as many people make it, and not nearly as easy as others like to pretend. Successful investors make decisions based on what is, rather than what they want to believe or what experts predict. The key is to invest in quality assets, hold on to what works and minimize losses on what doesn’t. In my experience, this approach provides a more confident and tax efficient path to wealth building.

You’ve got to think about big things while you’re doing small things,
so that all the small things go in the right direction.
- Alvin Toffler

What I believe about…

Diversification
We live in a dangerous, unpredictable world which makes diversification important. Protection does not come from spreading money across highly correlated investments. Owning a dozen companies with different return and risk drivers can offer better diversification than owning an index with 500 holdings concentrated in a handful of tech companies. The most effective diversification, in my mind, includes having money held back for a rainy day. Equity investments of all types tend to fall into bargain territory at the same time, effectively increasing the buying power of cash. In a crisis, cash is king.

Government
The government's influence through stimulus, tariffs, taxes, and regulation has increased, requiring greater weight in investment decisions. During the pandemic, the federal government injected more than five trillion dollars of stimulus, pushing up the price of stocks and just about everything else. We would never count on government action to save the day. The only thing I believe you can truly count on the government to do is to increase the supply of dollars making cash a poor performer in real terms over the long haul.

Indexing
Indexing, in my view, is better than most strategies. It’s low cost and tax efficient, two very good things. Plus, putting investments on “autopilot” tends to reduce counterproductive meddling. The problem today is that major indexes are heavily concentrated in a handful of technology stocks, making them riskier than many realize. Index funds are low cost but not low risk. Owning the “market” feels good and gains popularity in bull markets. All investors, including indexers, are tested at some point. Owning companies you know well can enhance confidence and reduce the risk of costly mistakes when market storms hit. Investors must handle crises well to achieve long-term success.

Leverage
Leverage makes the good times better and the bad times worse. Financing assets that produce highly predictable cash flows can make sense. Using debt to fund stock purchases or risky loans is another story. The use of debt tends to climb in good times as confidence increases along with asset prices. Over-levered companies and investors risk needing to raise cash when bad times hit. Rule #1 for investors is to never do anything that makes you vulnerable to becoming a forced seller. Sellers in a crisis rarely recover. Asset quality and stable cash flows plus low debt cost and a large equity cushion are a must when using leverage.

Momentum

There has been massive increase in momentum-based market volatility. Algorithmic trading and index investing dominate transaction volume and drive wider price swings. Today, less than 10% of trades are directed by humans acting on investment analysis. In my view, this means investors cannot count on a bargain valuation to support security prices. In the short-to-medium term, momentum's gravitational pull is stronger than intrinsic value's. Our work suggests investors are better served to wait to see evidence that momentum has begun to shift before investing.

Portfolio Management

To me portfolio management is about compounding returns over long periods in successful investments and limiting losses on unsuccessful ones. Make ten investments and two are likely to do better than imagined possible and two are likely to be big disappointments. It's the nature of dealing with many variables and much uncertainty. If every position is working at the same time, you do not have a diversified portfolio, you have a concentrated bet. A portfolio should include assets with different risk and reward drivers. When a company's stock trades off, stick with the ones that are simply out of favor in the market but sell the ones with deteriorating fundamentals. Let company results, not market swings or bargain valuations, drive decisions.

Speculation

Speculative waves come one after another. They typically start with an exciting new idea that has some merit and mystery—often a promising emerging market or breakthrough technology. Rising prices create excitement and attract more investors in a positive feedback loop. The fear of missing out on "easy money" pulls more into the vortex. Wall Street launches one alluring product after another, feeding booming investor demand. Prices rise exponentially until reality sets in and the bubble bursts. In the end, most speculators lose while the agents involved pocket profits and move on to promote the next big thing.

Uncertainty

Big decisions involve uncertainty. This may be unpleasant to think about but pretending to know for certain is dangerous. If you do not know the downside of a decision, you do not fully understand it. Bad advisors present options as if they are "no brainers". Perhaps because the risks are all yours? When evaluating options, study the downside. How could it go wrong? How bad could it be if it did? How might you limit your losses or know when to get out? Would you even be able to get out? Is the risk worth the potential upside? Pass on anything where the downside is unknown or unacceptable.

Volatility

The downside of market liquidity is volatility. Private transactions tend to dry up during crises, giving the appearance of stable values while trading volume spikes in publicly traded stocks and other liquid markets. The selling rush pushes prices lower, fueling fear and more selling, sending prices even lower. Falling prices create real danger, especially for fragile investors and owners of low-quality assets. They also create opportunities to acquire high-quality assets from distressed sellers at attractive prices. To be successful investing in liquid markets you must be able to recognize the difference between market level stress and asset level stress. Buying high-quality assets in distressed markets requires some gumption and can work wonders for long-term performance.

What to Buy
Well-managed companies with competitive advantages in secular growth industries can make great investments. Dividends are nice but total return drives investment results. Companies that are reinvesting profits at high returns can be great wealth compounders. Buying them when valuations are attractive relative to interest rates and growth expectations can help reduce risk and increase returns. The key is buying to own rather than buying to sell. The idea is to let the market work for you rather than trying to outsmart it. Owning companies that you're not worried about selling makes it easier to hold on through market downturns which is critical to achieving good long-term results.

When to Buy
Performance chasers like to buy after a stock has run up, while bargain hunters prefer to buy after a stock has fallen. Either strategy can work when buying high-quality companies and holding for a long time. Success is less likely if you trade around a lot. My favorite time to buy is after a market sell-off when investors are gloomy, and valuations reflect pessimism. That said, it's better to be a consistent buyer than to sit around waiting for the market to fall. Inflation is inherent in the financial system, putting time on the side of high-quality asset owners.

When to Sell
The saying, "you don't make money until you sell", is dumb. Wealth is created through owning, not selling. Bezos, Buffett, and Zuckerberg did not become billionaires by selling. The worst time to sell is when the market is collapsing in fear. The market is an auction; a rush of sellers is good for buyers. Selling decisions should be based on analysis of the holding not some sudden fear of the future. If a company is losing customers or management is making poor decisions, you should move on. Pay close attention to what you own and ignore market forecasts. If the company is losing market share it is most often better to sell than hope for a turnaround.

About investing and life…

Great things in business are never done by one person.
They are done by a team of people.
- Steve Jobs

The best results come from intense collaboration between people with different perspectives and expertise all sharing a common goal of excellence. Look into your favorite creations and you'll likely find they were produced by a small group. The most effective collaborations involve disagreement and debate without defensiveness. It's a lot messier than a hierarchical, command and control approach, but the outcomes are often much better. When the people you are working with care enough to disagree and respect enough to listen, you're with the right people and on your way to better decisions and outcomes.

Each man delights in the work that suits him best.
- Homer, *The Odyssey*

For many, the goal is not to have to work. To me, the happier goal is to do good work. It does not have to be for money of course. It can be doing any number of wonderful things. The idea is to invest your time, energy and thought into improving something that is important to you whether it's your garden, golf game or portfolio. It involves trial and error, sweating the details, paying close attention, adjusting as you learn, knowing yourself and getting help from others. If you are just antsy to get it done, the results will probably be disappointing. When you are doing something with excellence there is a calm sense of discovery and progress, typically uneven, but progress, nonetheless.

I never worry about the problem.
I worry about the solution.
- Shaquille O'Neal

For many the goal is not to have to worry. To me, the more realistic goal is to worry about things that matter and that you can do something about. We are going to worry, it's human nature. People who worry about big things like politics, the economy, the market, etc. tend to feel helpless, victimized by enemies or forces beyond their control. I worry about many things, but I don't worry about the market. The market will do its job, it will provide liquidity. I worry about doing my job. Doing the work required to recognize and take advantage of the opportunities that big macro events present.

Always take your job seriously, never yourself.
- General Fox Conner

You can make a great decision, suffer bad luck and end up with a disappointing result. You can make a bad decision, get lucky and have a great result. It happens often. Good investors and happy people recognize that much is left to chance. The big decisions in life—marriage, kids, career, investments, etc.— involve chance. The happiest, most successful people I know understand this and count their good fortune when things go well. Those who confuse good luck with skill are likely to get themselves into big trouble. People that live full, happy lives tend to take bad luck in stride as best they can and count their lucky breaks over and over with gratitude. The ability to laugh at yourself, learn from your mistakes, push through the bad breaks and recognize the wonderful good luck you have benefited from is, I think, fundamental to a happy, productive life.

The doers are the major thinkers.
The people that create change…are both the thinker and doer in one person.
- Steve Jobs

We learn the most by doing. If you are not doing the work it's best to learn from those who are. The closer you are to the doers the more you will learn and the faster you will learn it. Titles, degrees, credentials etc. tend to be over-rated, while those doing the work tend to be undervalued. It is easy for experts to sound smart, safely removed from the situation, proclaiming with certainty what should be done. They are mostly unaccountable critics who sound impressive but add little to no value. Do the work, learn from doing it, be accountable, and stay closely connected to other doers doing good work. You'll learn more, add more value, go farther and have more fun.

About the current investment environment…

There are old pilots and bold pilots,
but no old, bold pilots.
- E. Hamilton Lee

Currently we are in a "risk-on" environment. Excitement over artificial intelligence is a symptom of that, I think. Sure, AI's potential is massive. The problem, from an investment perspective, is that not even the experts know how it's going to play out. Leading technology companies are spending billions with comparatively little revenue to show for it. For now, one chip maker is raking in the lion's share of the AI profits. If AI follows the path of most major leaps in technology, there is no need to rush in. Investor excitement will fade as most AI ventures disappoint, making prices more attractive as the winners emerge.

Keep your eye clear, and hit'em where they ain't.
- Willie Keeler

Seven "magnificent" companies currently dominate market attention and performance. Stock indexes are at record levels and valuations look dangerously high. While we think the market is overvalued, we are finding a few attractive opportunities in growing businesses, leaders in industries that are not in the market spotlight. In a risk-on market, the crowd is not as impressed by current profits as it is excited about the potential for future profits. This too will change. The key is to take advantage of the opportunities the market provides and not to get caught up in following the crowd. Earning a decent interest rate is better than taking a risk where everything has to go just right. Investing is not about peering into the future or betting on the next big thing, it is about investing in assets that are making money today and on a path to making more money tomorrow.

Investors should retain enough safe assets, like cash and bonds,
to ride out any market volatility and
allow the compounding effect of stock investments to do their magic.
- Warren Buffett

I started this letter noting that I've been investing real money for real people for a really long time. 34 years to be exact. I've seen firsthand that what investors do during crises is the most important driver of long-term performance. When I started in 1991 I was surprised to see that the 1987 market crash dominated investors' mindset and portfolio performance, for better or worse. Those that did not have the financial or emotional wherewithal to handle the crash sold under pressure, thinking they could wait for times that were not so uncertain. I saw the same thing play out following the dotcom bubble burst, the 9/11 terrorist attacks, the financial crisis, the pandemic and other corrections in between. Selling in a market panic can turn a temporary problem into a permanent one.

Every investment strategy involves a sacrifice, and the sacrifice that comes with being prepared for busts is making less during booms. Investors in aggressive strategies have bragging rights when markets are surging. Markets fall, correct, or collapse only a small fraction of the time, but it is during those times that the seeds of great long-term performance are planted. We are currently invested to benefit from market progress and inflation, while holding back funds to take advantage of a market downturn. In an uncertain world where inflation is wired in, I believe that each portfolio and each company in the portfolio needs to be in a position to be an opportunistic buyer. For me, the world is a much better place when you are participating in economic growth and good times, all while knowing you're ready, willing and able to capitalize on any market stress that comes along.

Life is like riding a bicycle.
To keep your balance, you must keep moving.
- Albert Einstein

All this talk about being prepared to take advantage of the next crisis can have a costly impact on an investor's mindset. It can wrongly imply that we should simply wait around for a better day to invest when bargains are easy to find. The reality is that investing is never easy. In my experience, the most successful investors are grinders, doing what they think best, little by little, each day. The doomsdayers sitting around waiting for something bad to happen tend to continue to sit around during a crisis, sure that things will only get worse. While I think compounding is the most powerful force of all, inertia might be second.

About what's most important…

I have been lucky to work closely with some amazing people over my 34 years of investing. Great investors and more importantly great people who have created value for their families and made contributions to their communities that will improve lives for generations. Some have passed away, yet I am reminded of them almost every day. Thinking about them now, I realize how different they were from each other, they had different backgrounds, different political views, different attitudes and preferences about most anything and everything.

What I think is far more important is what they held in common. They had a fascination with learning how things work, a deep belief in personal responsibility, and a profoundly unselfish optimism. They were both unconventional and practical. Both frugal and generous. They moved forward incrementally rather than trying to make dramatic leaps. They were in the present, tracked progress closely, always with an eye on the long-term implications. They were not in a hurry; they focused on identifying and executing the next good step, in no rush to get to some big goal.

They loved getting better at whatever they were doing. They did not love money. They loved making money or, better said, they loved putting money to work. They were creative about finding low cost, low risk ways to finance growth and help manage taxes. They hated wasting money or time. I'm thinking now of one who would call me often, tell me what was on his mind and ask what I was seeing. He was smart, always had a reason for me to keep it brief, often an imminent tee time. I never was good at keeping it brief.

They never viewed themselves as victims, even in times of personal tragedy. They had bad times, sad times, bouts with depression and somehow found their way out. Problems were part of life and solutions were always out there to be discovered. They lived life forward and died like they lived. In their last days, they focused on the practical things that needed to be done for a better longer term—for their families, their businesses and the causes they believed in most deeply. All with a thankful spirit about the time and opportunities they had been given.

Phil McCauley III
March 2025