

The Quarterly Report

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Pessimism Abounds

| INSIDE STORY |



AssuredPartners
INVESTMENT ADVISORS

3500 Piedmont Road, Suite 301, Atlanta, GA 30305
T 800.417.3804 | www.ironcapitaladvisors.com

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Pessimism Abounds

We were in an outdoor café in downtown Warsaw. Invesco had entered into a joint venture with a French insurance company and the Polish Post Office as one of a small handful of western asset managers partnering with what seemed like unlikely local firms to give Polish citizens options for managing their government retirement benefits, similar to our Social Security. (Yes, there is some irony that a former communist country had no issue privatizing their program while the U.S. never could, but that is another story.)

Sitting in that café, my two French colleagues and I were in complete agreement: Warsaw was a much better city than we had ever imagined. Before changing your European tour itinerary, let me be clear – we all agreed that in this case, low expectations helped. We had all been overly pessimistic about what we would find in this formerly communist city.

In investing, as with travel, low expectations can be a good thing. Look back at 2023 and 2024, when most of Wall Street kept saying that recession was right around the corner. The so-called yield curve had inverted, and groupthink said that must mean recession. For those who speak English and not invest-speak, the yield curve is the line that forms when one plots the various interest rates of U.S. Treasury obligations of different maturities.

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Quick reminder: bonds are simple loans, so when the government borrows money, it issues bonds. Government bonds are like other loans in that they can be for differing periods of time. A credit card allows a responsible user to borrow money today and pay it back at zero interest when the bill comes next month, or not pay it back and pay outrageous interest. A car loan is traditionally for five years or less, although they are getting longer as car prices increase. A mortgage can be for 15 or 30 years. Similarly, the government borrows for different amounts of time ranging from 90 days to 30 years. All else being equal, the longer an investor has to wait to get her money back, the higher interest rate she will demand.

This means the “normal” yield curve slopes up and to the right. The rate on 10-year bonds will be higher than the rate of 5-year bonds, which are higher than 2-year bonds, etc.

While this relationship generally holds, there are times when it doesn’t, and the post Covid world has been one of those times. When the longer termed bonds have lower interest rates than shorter term bonds, we say the yield curve has inverted. Historically this has often signaled a recession, but that did not hold up this time around, much to the embarrassment of many pundits. Too many got fixated on this one indicator and refused to see the rest of the positive picture.

Pessimism can be blinding, and it is an easy thing to fall into. I have been writing these Quarterly Reports for more than 20 years now and one of my favorites from early on referenced the movie “Men in Black.” To quote Agent K (Tommy Lee Jones), “There’s always an Arquillian Battle Cruiser, or a Corillian Death Ray, or an intergalactic plague that is about to wipe out all life on this miserable little planet...”. I don’t know if any of that is factual, but Agent K has a good point: There is always something – a geopolitical issue, high valuations, uncontrollable government debt, and yes, as we have witnessed, even a plague – ready to wipe out our 401(k)s.

Fear sells, and there are plenty of people willing to take advantage of that opportunity. One need to look no further than cable news and social media. My colleague Michael Smith often says that Bears (to use the market-based pessimism) always sound smarter than Bulls. He, too, has a point: Today, Bears can talk about wars in Eastern Europe and the Middle East; runaway government debt throughout the developed world; sky-high market valuations; a weakening labor market; stubborn inflation; government shutdowns; and so on. So many Carillion Death Rays aimed right at this miserable little planet, woe is us.

One can grab any one of those topics and spin a tale of doom and gloom about the stock market and even the future of the United States or all of Western Civilization, for that matter. He can make it sound deep and well-conceived. On the other hand, the bullish positive message just sounds naïve: “It will all be okay, guys.” That just doesn’t resonate against all of the pessimism, which is unfortunate, because while the future is always uncertain, “it will all be okay” is the most probable outcome.

This is why we so often talk about prudent investing being done from the bottom-up. It is far easier to analyze a specific company and make the determination for whether to invest in its stock than it is to try to figure out what will happen in Ukraine, how that will impact global natural gas prices, and how much of an input is natural gas to income statements of the S&P 500 companies? That rabbit hole is intellectually gratifying as we love to make connections and show off how many levels of reason we can spiral, but will it actually provide investable insight? Doubtful.

So how do we deal with all the potential negatives? Prudent investing is also risk-averse. Our industry has defined risk as volatility, but this is problematic: Volatility goes in both directions, and investors tend not to be concerned with upside volatility. Volatility is also backwards-looking. The mortgage-backed securities that nearly destroyed the world in the 2008 Great Recession had almost no volatility until they blew up. The most volatile stocks often deliver the highest returns, hence the relationship between risk and reward. We like the old idea of risk, which Benjamin Graham referred to as the Margin of Safety. Price relative to value is, in our opinion, the best measure of risk. When the calculatable value of a company is significantly above the price of its stock, then there is a high margin of safety; if it is the other way around, then risk is real.

The obvious question is: If this is how we see the world, then how could we not be disturbed by the market being at record highs? Because that isn't a real measure. "Record highs" looks only at price and does not involve value. Also, the market is supposed to be at all-time highs; that is like saying my 15-year-old daughter is at her all-time high height. Children grow, that is what they do. If she were not at her all-time high height, we would be taking her to the doctor to figure out what is wrong. While markets don't grow in straight lines like children, they do grow over time so being at an all time high is normal.

This is also problematic because it is a top-down view of the whole market, however one wishes to define that term, and the better view is from the bottom-up. There are plenty of companies that are not at all-time highs. One example would be Duolingo, a company that provides a language learning app. This stock is down 0.74 percent year-to-date through September, while its earnings per share are up 71.43 percent over the last twelve months. This is just for educational purposes and not a recommendation, but this one example has grown as a business while its stock price has dropped. So, it is not at "all-time highs." There are plenty of other examples.

Pfizer's stock price is more than 25 percent below where it was three years ago. Its price-to-earnings ratio is just 8.59 based on next year's estimated earnings, while it is 14 times the actual earnings from the last twelve months. So, when people fret about all-time highs and how incredibly expensive the stock market is, they are clearly not talking about Pfizer.

These examples are just to show that what is happening below the surface of the market is not always in line with the narrative of the day. The S&P 500 index is at all-time highs and very expensive from an

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The 2nd quarter 2025 GDP growth came in up 3.8 percent, thanks to a sharp drop in imports. GDPNow shows the economy growing by 3.8 percent once again in the 3rd quarter, but this is not being updated due to the government shutdown. The first half of 2025 averaged out to 1.6 percent growth and that is probably the most accurate picture of the current economy.

REVIEW of ECONOMY

The official unemployment rate was 4.3 percent through August. The economy only created 22,000 jobs. That isn't nearly enough for a healthy economy. We won't have numbers for September until the government reopens.

Inflation is 2.9 percent based on the latest consumer price index report. Inflation has inched up although it is still less than many feared. The producer price index, which tracks wholesale prices, is up 2.6 percent over the last 12 months, the same as last quarter. +

The market rose in the 3rd quarter.

For the quarter the S&P 500 finished up 8.12 percent, while small company stocks represented by the Russell 2000 index were up 12.29 percent. Growth outperformed in large caps with the Russell 1000 Growth index up 10.51 percent while the value index was up 5.33 percent. For small companies value outperformed up 12.60 percent, and the growth index was up 12.19 percent.

REVIEW of MARKETS

Bonds were also up. The Bloomberg U.S. Aggregate Bond index ended up 2.03 percent. High yield bonds rose 2.40 percent. Bond yields dropped slightly.

International stocks kept up the solid performance. The EAFE index finished up 4.77 percent and the MSCI Emerging Markets index ended the quarter up 10.64 percent. +

MARKET forecast

The world is chaotic but the market keeps climbing. With all the news the one consistently positive thing has been corporate earnings, and that is what drives markets. We are still optimistic going into the 4th quarter.

International will likely continue to do relatively well as a weak dollar will assist U.S. investors in foreign markets. Small companies remain a better value, and they finally got some good momentum this past quarter. We suspect that will continue.

Bonds have done their job and stabilized in this range just above 4 percent. The Fed has begun to lower rates as we suspected. This will likely steepen the yield curve with short-term rates falling, but the longer-term rates remaining in their range. +

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historical basis, but that is skewed by some very large outliers. There are lots of stocks that do not fit that description.

Being optimistic in the face of market pessimism is often very fruitful. As the old adage goes, we want to buy when others are selling and sell when others are buying. However, pessimism is going deeper: According to a joint poll by The Wall Street Journal and the National Opinion Research Center (NORC), nearly 70 percent of people said they believe the American dream – that if you work hard, you will get ahead – no longer holds true or never did, the highest level in nearly 15 years of surveys.

This is truly frightening. One of the secrets to America's success is that we are a relentlessly optimistic people. We believe the future will be better, and that is important because in many ways this is a self-fulfilling prophecy. As Henry Ford once said, "Whether you think you can or think you can't, you are right."

The WSJ-NORC poll did show a small uptick in people believing the economy was good, but in the September 1 article, they followed that insight with this excerpt: "And yet many people in the survey, as well as in interviews, said they felt a sense of economic fragility, even if their finances were adequate or secure today. In a generational cascade, majorities said the prior generation had an easier time buying a home, starting a business, or being a full-time parent rather than in the workforce, while majorities also said they lacked confidence that the next generation could buy a home or save adequately for retirement."

Home ownership has been such a central part of the "American dream," and there certainly are issues today. The main problem with housing today is lack of supply, and especially the supply of starter homes. There are multiple factors here but one of the largest is runaway

regulation. A few years ago, California mandated that all new houses had to have solar panels. Whether or not one believes this is a good idea, there is no question that it raises the cost of building homes. Solar panels for a house are not cheap. These types of rules make what is already hard seem impossible.

The ability to start a business is directly related to the level of regulation in the particular business. In the early 1980s, a few years after my father moved us from our North Carolina home to South Florida, Dad had the great idea of introducing Floridians to North Carolina barbeque. Today everyone knows of North Carolina barbeque, but that was not the case 40 years ago. When my father proposed the idea to the Stamey family, owners of Stamey's BBQ in Greensboro, NC, they quickly told him that it couldn't be done. The Florida environmental regulations would not allow for all that hickory smoke to go into the atmosphere. Since then, there have been 40+ years of regulation piled on top of what existed then. Some of it may be good, some bad, but all of it makes it more difficult to start a business.

We need to get back some of that American optimism. To fix the real problems in our system we will need some thoughtful regulatory reform; Meanwhile, we can focus on what we can control. From an investing standpoint, low expectations can be a good thing. It's boring and it doesn't sound nearly as intelligent as a complex conspiracy of our ultimate doom, but if we prudently invest from the bottom-up and manage our risk, things really will be okay, guys.

Warm regards,



CHUCK OSBORNE, CFA Managing Director