Investor Letter
Third Quarter 2025

Market Update

The third quarter of 2025 was another strong one for financial markets, with the S&P 500 Total Return Index rising 8.1%, the Nasdaq rising 11.2% and the Bloomberg Aggregate Bond Index rising 2.0%. Among other factors, market strength reflected outstanding second quarter earnings, as reported during the third quarter, with S&P 500 earnings rising 11.7%. This is the second consecutive quarter of double-digit growth. Communications services led with the +48% earnings growth, information technology with +23%, financials with +12% and healthcare with +8.3%. Excluding the large cap tech names, earnings for the S&P 500 stocks rose a respectable 7.4%.

Aside from the earnings news, the biggest financial event of the quarter was the decision in September by the Federal Reserve to lower the discount rate by one quarter of a percent. The rate cut was the first since 2024 and reflected two important factors: first, there are signs of weakening in the labor market. Second, the Fed believes the discount rate is above the so called "neutral" rate, meaning interest rates are slowing economic growth.

The desire to cut rates to help job growth was offset by the fact that inflation is still higher than the Fed's target of 2%. As Chair Powell said in his press conference, "there is no risk-free path" for the Fed at this point.

International markets have been good performers this year. A number of analysts have predicted that international markets could be out performers for a number of years as they catch up to the US market. We see it differently. Most of the outperformance this year has come from dollar weakness. While this could continue for a while, it probably isn't a long-term trend since the US has such compelling economic fundamentals compared to Europe or Asia. Second, the caliber of companies to invest in in the US continues to be much higher than overseas. While this doesn't guarantee outperformance every year especially when valuations in the US are at high levels, it does in our view make it likely the US will be a much better long-term performer.

The Role of Fixed Income in a Diversified Portfolio

While equity investments receive most of the attention from investors, fixed income investments can be an important part of a well-structured portfolio. At Western Pacific, we seek to build portfolios which combine equity investments with fixed income in a way which balances the desire of investors for a combination of capital preservation, growth, inflation protection, stability, and reliable income generation. Fixed income is an option for all types of investors, although the specific way to implement a fixed income allocation varies based on the investors' specific situation and needs.

The tradeoff between stocks and bonds involves one of the most fundamental choices which investors are called on to make, specifically the tradeoff between a higher expected return (with stocks) and a higher certainty of return (with bonds). The factors impacting this tradeoff are different for each investor and also differ based on prevailing market conditions. (This commentary will focus on investors who are retired and draw an income from their portfolio. The asset allocation decision for investors who are working and not drawing on their investment portfolios involves a different set of criteria.)

The investor-specific factors which impact the equity and fixed income decision include the following: First, the overall financial situation of the investor. Put simply, an investor with substantial assets relative to their expected expenses is better positioned to ride out significant stock market swings than an investor of more modest means. This means such investors may be more comfortable with a larger weighting in equities, since equities have a higher expected return but are more volatile. On the other hand, investors who don't have the ability to weather a severe market downturn may prefer to have a higher weighting in bonds, which reduce portfolio volatility and provide a more predictable income stream.

A second (related) factor is the personal risk tolerance of the investor. For reasons which are beyond the scope of this article, some investors are more comfortable with more volatile portfolios than others. This difference may be partly attributable to differing levels of understanding of financial markets, but in our experience it is also attributable to differing personality types. Our role is to help our clients with the educational component, listen to their concerns about risk and structure portfolios which take account of these factors. Third, the age of the investor impacts the asset allocation decision, with older investors generally preferring to hold more bonds. That said, increasing life expectancies mean that retired investors no longer should automatically have portfolios full of fixed income instruments.

Market specific factors which impact the tradeoff between stocks and bonds are also significant. It is well known that equity markets go through periods of under and overvaluation based on such factors as the economy, earnings growth, inflation and emerging technologies. Less well understood is that bond markets also swing between under and overvalued. A simple but instructive way of thinking about this is to consider the interest rate on an investment grade bond and compare it to the inflation rate. (Since investment grade bonds don't appreciate with earnings growth like stocks, the interest rate is the primary way in which bond investors make a return.) It is reasonable to assume that investors prefer a positive rate of return in real terms, in other words after accounting for inflation. So if the current interest rate is lower than the rate of inflation, the real rate of return is negative, and a reasonable case may be made that bonds are overvalued. Similarly, if the interest rate on bonds is higher than the inflation rate, bonds may be attractive or undervalued. There are a number of significant caveats to this analysis which we are happy to discuss with those who are interested, but the basic concept is important to understand.

An example of bond overvaluation was seen in the early part of this decade when the real rate of interest rate on US government debt turned negative for 15 months. (If you are wondering who would buy a bond with a negative real interest rate, one answer is institutional investors such as Silicon Valley Bank, which subsequently failed). As with equity markets, overvaluation can last for longer periods of time than one would expect, but eventually they come to an end. In this case the end was the bond market crash of 2022, which saw the largest decline in the US 10-year bond on record (interestingly, records go back to 1788). Since then, the interest rate on bonds has risen substantially to the point where the expected real return is again positive. The overvaluation seen prior to the crash of 2022 was the reason Western Pacific clients owned no bonds during the period, although we did have short term securities which held little or no interest rate risk.

Stocks Have a Higher Expected Return, Why Not just Stick with Them?

It is tempting to think that, since stocks have a higher expected return than bonds, that investors should always put virtually all their money in the stock market. This thinking is especially easy to fall into during a prolonged bull market. While this may make sense for some investors, there are some very important caveats. One of these has to do with the difference between short and long term returns. In a previous investor letter we highlighted a study by Vanguard that provided a great illustration of this point. The study pointed out that the long term return from stocks was 10.5%, which is a return that many investors would be satisfied with. But the study went on to show that while the long term return to equities is 10.5%, the annual returns vary widely. In fact, *the annual return on equities is only between 8% and 12% around 8% of the time.* This means an investor who invests over a 50 year period would only expect to see four (8% of 50) so-called "normal" years of returns between eight and twelve percent in their investing lifetime. For investors who are in the retirement phase of their lives, this level of volatility may be more than they are interested in. A fixed income allocation helps investors address this issue by smoothing portfolio returns in most years.

Are Bonds a Hedge Against a Stock Market Decline?

Bonds are often said to provide a hedge against owning equities. The logic is that during an economic expansion, stocks may rise, while bonds may be held back as the strong economy pushes up interest rates. Similarly, when the economy slows, stocks might fall but bonds might rise as lower demand for credit causes interest rates to decline. This relationship holds much of the time, but as investors saw in 2022 sometimes it doesn't. The reason this relationship did not hold up in 2022 was that inflation rose significantly. This caused investors to push down both stocks (due to a forecasted recession) and bonds (due to expected higher interest rates to make up for the inflation) at the same time. As investors hadn't experienced this scenario since the 1970s, it caught many of them by surprise. The bottom line is that stocks and bonds prices generally move in opposite directions, except during an inflation scare when they may move in tandem.

Bond Ladders vs. Bond Funds

In many cases, Western Pacific prefers that fixed income investments be structured in a bond ladder. While bond funds offer convenience and broad diversification, individual bonds structured in ladders can provide superior risk management for many investors. The fundamental difference lies in maturity certainty: individual bonds held to maturity return the principal at face value regardless of what happens to bond prices in between, while bond funds expose investors to ongoing interest rate risk without definitive maturity dates.

A bond ladder is simply a portfolio of individual bonds with staggered maturity dates. For example, an investor might buy bonds that mature in one year, two years, three years, and so on. As each bond matures, the investor might reinvest the proceeds in a new bond at the end of the ladder. Compared to owning a single bond, a ladder increases diversification and can reduce various risks while providing a predictable stream of cash flow.

Bond ladders offer several distinct advantages. First, they provide better interest rate risk management. Individual bonds held to maturity maintain their value over time and offer a fixed yield, while fund investors face continuous risk of capital losses during periods when interest rates rise. Second, ladders provide cash flow certainty through predetermined maturity dates that can be aligned with specific financial needs. This timing precision proves invaluable when planning for known expenses. Third, as bonds mature, investors can assess current market conditions and reinvest proceeds when opportunities arise. In a rising interest rate environment, investors can reinvest the principal at higher yields as each bond matures. Finally, individual bonds typically involve minimal ongoing costs compared to fund management fees.

Conclusion

Fixed income securities offer several important benefits for investors including reducing volatility, providing a more certain income stream, and preserving capital. After a period where bonds were often priced to guarantee negative real returns, bonds are once again priced to offer a positive yield after taking inflation into account.

The key factors investors should consider when determining their fixed income allocation include: their overall financial situation and ability to weather market volatility, their personal risk tolerance and comfort with uncertainty, the current valuation of both stock and bond markets, and their specific cash flow needs and timing requirements. The choice between individual bonds and funds depends largely on portfolio size, risk preferences, and specific financial objectives.

In an environment where stocks trade at elevated levels and traditional diversification benefits have returned, bonds can provide the stability and income generation that many investors require for long-term success.

Thank you for being a client. As always, please feel free to reach out to us to discuss your portfolio.

William R. Andersen, CFA
Principal and Chief Investment Officer