

INVESTMENT COMMENTARY

Q4 2024 | JANUARY 27, 2025



Commentary Highlights

2024 RECAP

RATES RULE ALL

NEW RULE WITH
TERMINAL VALUE RISK

NEW BUYS

On the surface, 2024 appeared to be another banner year for equity markets, but beneath the hood, the story was categorically different. Even the surface-level narrative had its nuances. As the story goes, the S&P 500 performed admirably on the heels of AI enthusiasm. This is certainly true, with AI names like Nvidia, Broadcom, and Palantir standing out as three of the ten highest returners in the index. Moreover, AI fueled gains in companies like Vistra Corp, a Texas-based utility company, and GE Vernova, the power and energy division of General Electric, on the expectation that datacenter investments will require an acceleration of power supply development.

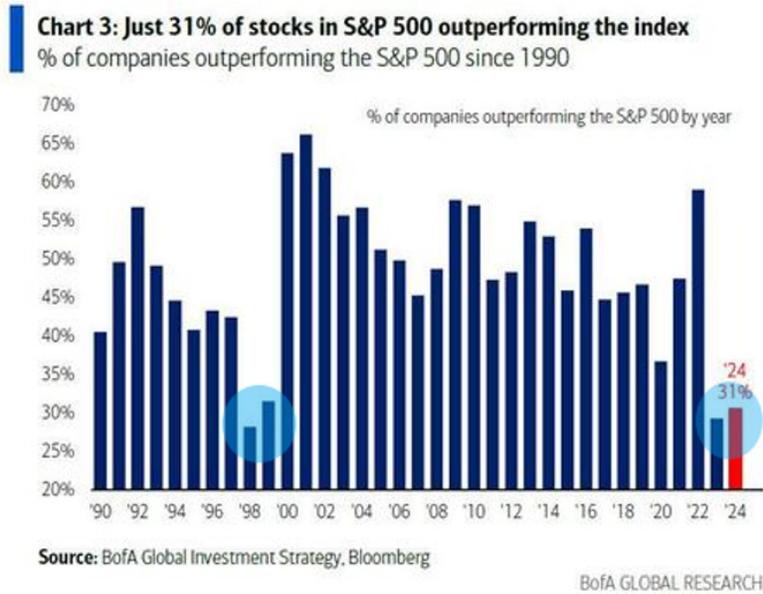
Beyond the AI-linked winners, durable large caps like Walmart and Costco surged, driven primarily by a steady increase in the multiple the market was willing to pay for these types of companies. Valuation multiples for these names climbed to levels not seen since the Dot-Com bubble, a time when their growth rates were significantly higher and from which gains were minimal for the next decade. In 2024, the market appeared to place no bounds on the valuation of perceived safety.

Outside of AI and perceived safety buckets, the broader market told a much bleaker story. Market practitioners frequently used the term "bad breadth" to describe the sorry state of affairs. Breadth typically refers to the number of stocks participating in a market rally, often

Building long-term portfolios through deeply researched investments.

RGAI.A.COM

measured by the percentage of stocks performing at or above the market’s overall performance. One chart, in our view, captures this phenomenon better than any other.¹



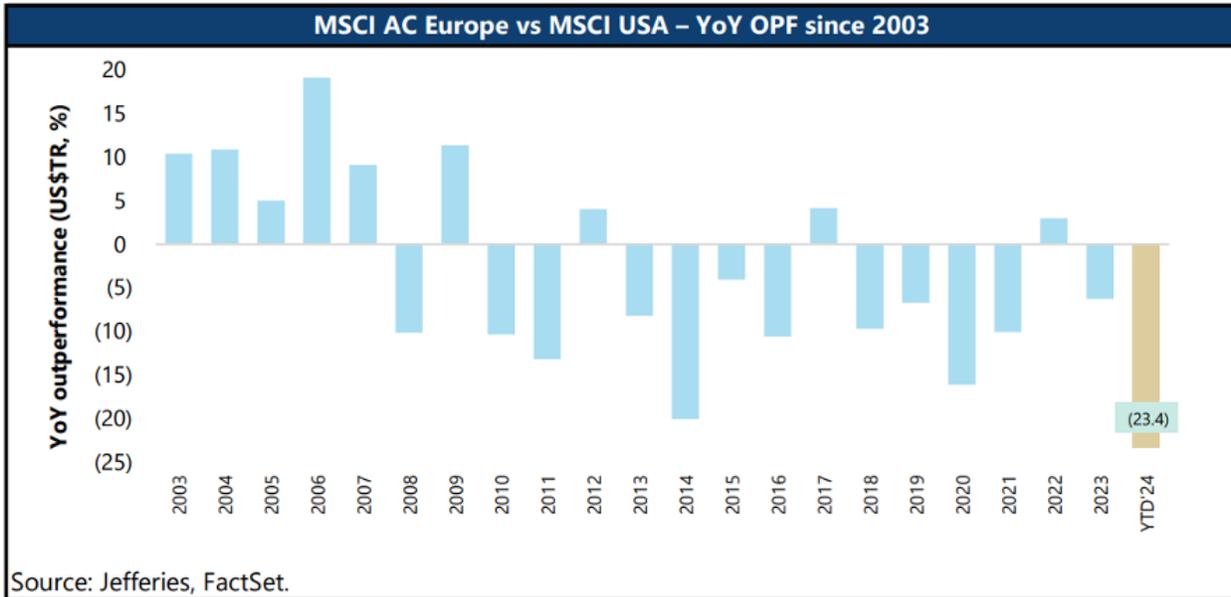
Over the past 35 years, only two other years have seen a smaller percentage of stocks outperform the index. Most years hover around the 50% mark, with a few defined by broader groups of stocks delivering outperformance. In 2024, however, market dynamics more closely resembled the Dot-Com era than anything else. While we would caution that the differences between today and the Dot-Com bubble are more notable than the similarities, the story of market participation remains the most significant narrative of 2024. Notably, this chart was produced in mid-December, yet breadth continued to deteriorate throughout the month. In fact, December registered an all-time low in market breadth.



1 <https://x.com/Barchart/status/1868505466176971169>

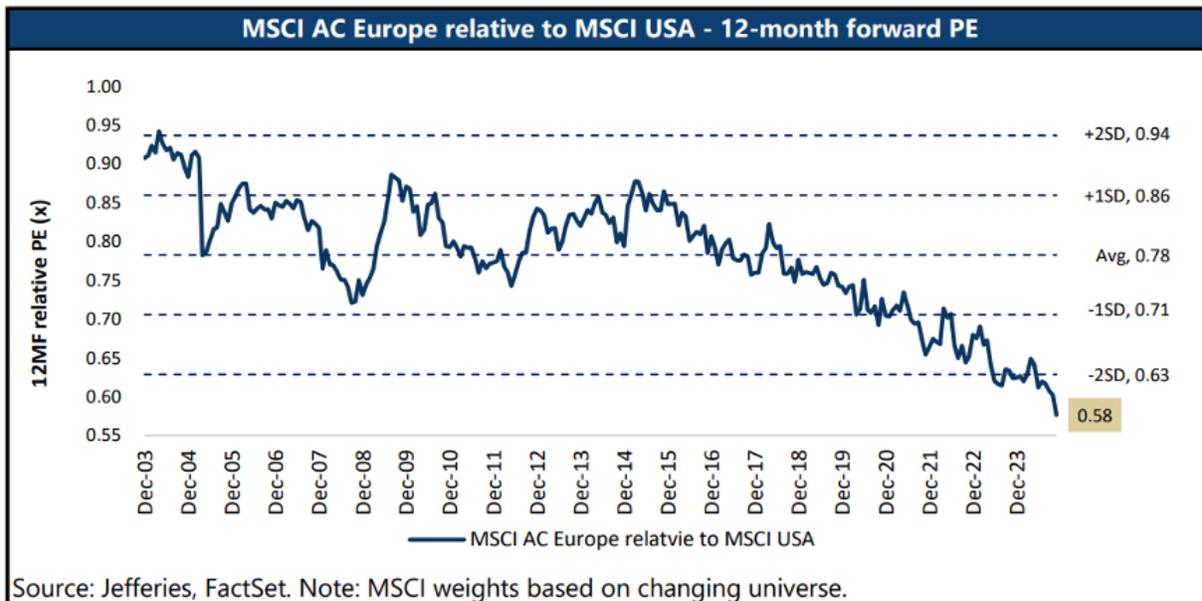
To broaden the story, the S&P 500 was essentially an island of performance in a world where little else worked. We have previously discussed at length the relative performance of the S&P 500 versus the Russell 2000, and that spread widened further over the year. However, the global isolation of the U.S. market became even more striking. In 2024, the S&P 500 outperformed the MSCI World ex-US Index by the largest margin in 27 years, with a staggering 24% differential.

With relative underperformance versus US hitting a record high in 2024...



Valuations in Europe are now the lowest they have ever been relative to those in the U.S.:

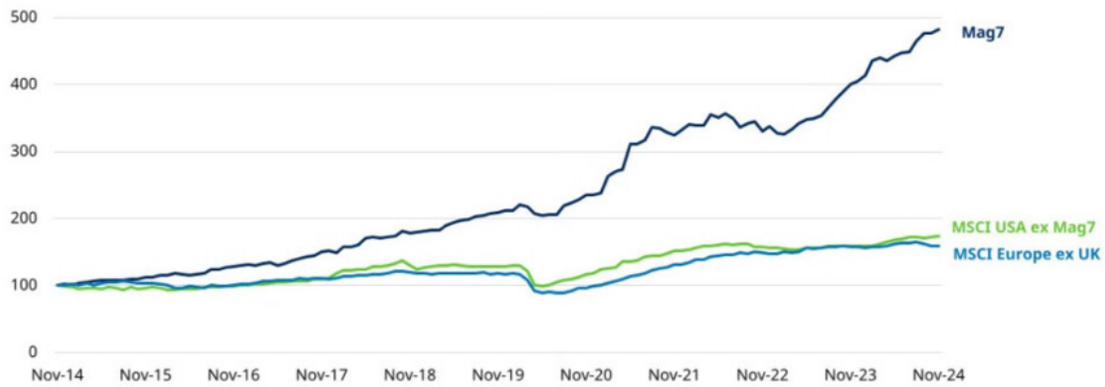
Europe is as cheap as it has ever been versus the US



This is despite growth being relatively similar between the U.S. and Europe when excluding the “Magnificent 7.”

8. Strip out the Magnificent-7 and European companies have been almost as good at growing earnings as US ones

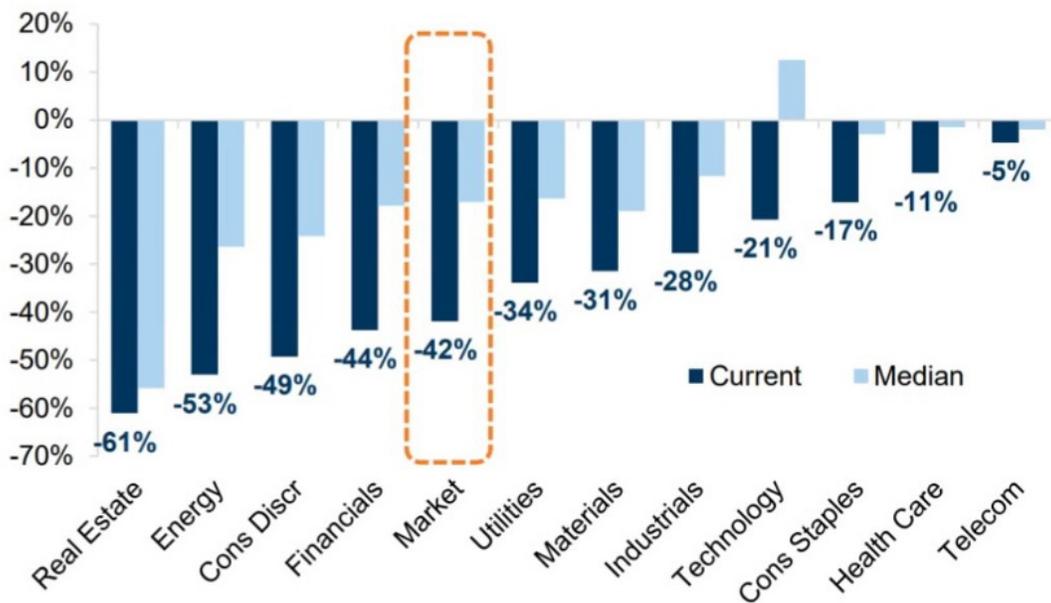
Next 12-month earnings, US in USD, Europe ex UK in EUR, indexed to 100



Past performance is not a guide to future performance and may not be repeated. The Magnificent-7 is the name given to Nvidia, Meta Platforms, Amazon, Apple, Alphabet, Microsoft, Tesla. Source: LSEG Datastream and Schroders. Data to 30 November. Please see relevant disclaimers on slide 55.

Notably, the equivalent earnings stream in Europe, on average, trades at a valuation discount of approximately 42% compared to the U.S.

Exhibit 12: Every sector on a bigger discount than history
Europe vs. US 12m fwd P/E Premium/(Discount). Data for last 20 years

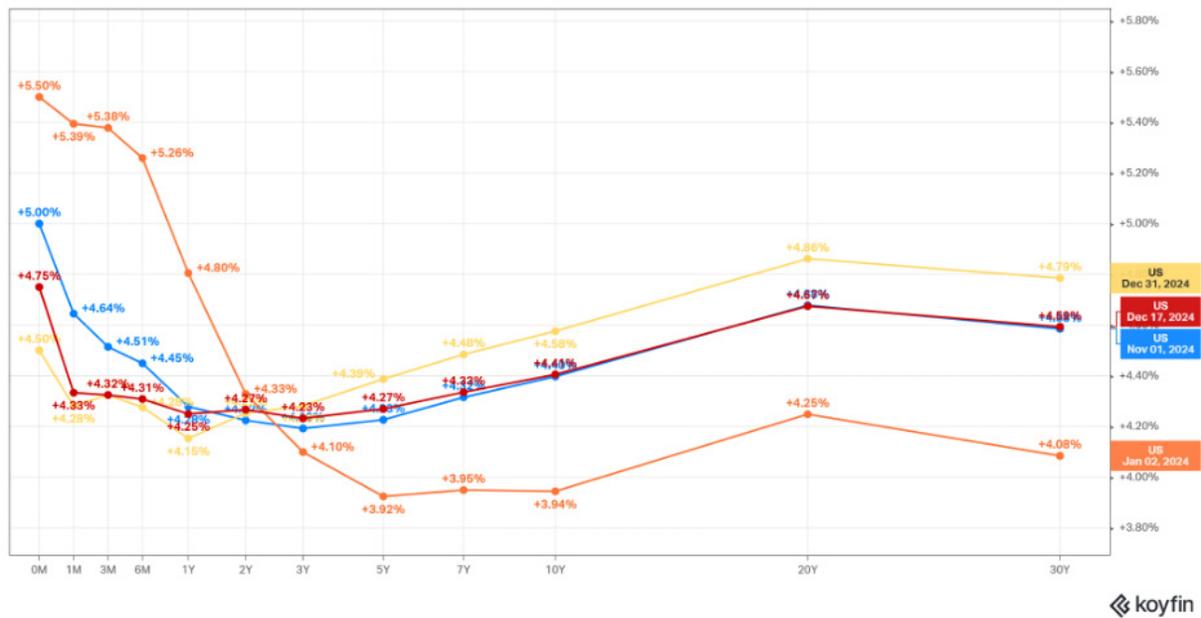


Source: FactSet, Datastream, Goldman Sachs Global Investment Research

We present this not to excuse our performance but to highlight how anomalous 2024 has been in the equity markets and to underscore where the greatest sources of tension currently lie. These tensions also represent areas with the most potential for future returns. Such imbalances cannot persist indefinitely, regardless of one’s perspective on AI or the geographical distribution of winners.

RATES RULE ALL:

All of this is unfolding within a broader economy that is as strong as any we have witnessed in our adult lives. In theory, such economic strength should broadly support equities. However, there is one significant way in which this strength creates a headwind: longer-term Treasury rates are rising, even as the Federal Reserve has cut interest rates. While this dynamic is not entirely atypical, the magnitude of the rise is particularly notable. Below, we present the yield curve at four key points in 2024:



At the start of the year, the yield curve was sharply inverted, but it has since transitioned to a more normal, pro-growth shape. Many have attributed the spike in long-term yields to the election results; however, it is clear that the pre-election yield curve on November 1, 2024, was strikingly similar to the yield curve on December 17, 2024—the day before the Fed’s “hawkish hike.” With the Fed signaling fewer rate cuts than previously expected in 2025, long-term rates (from three years onward) rose significantly—a trend that has continued into early 2025. The Fed’s language on inflation remains consistent with the progress seen so far: inflation is moving, albeit at a slower pace, toward the 2% target. Meanwhile, growth has continued to exceed expectations. While some now debate whether the Fed’s next move will be a hike rather than a cut, this appears more like a pause on the path to lower rates than a definitive shift in direction.

NEW RULE WITH TERMINAL VALUE RISK:

One idea we’ve reflected on extensively over the past few years is our tendency to favor attractive spreadsheet math over grappling with deeper questions about duration. A prime example is a company like Dropbox (NASDAQ: DBX). On paper, the numbers look incredibly compelling—both intrinsically, when constructing a DCF, and relatively, when comparing valuations to peers. However, the terminal value component—the projected value of the business beyond the explicit forecast period—remains an enduring

question mark. While we dedicate significant effort to evaluating the probability of terminal value risk materializing, this focus introduces several unfortunate side effects:

1. The market will continue to discount the company's multiple as long as questions about terminal value persist.
2. The stock's volatility will exceed that of the underlying business.
3. The investment will consume disproportionate mindshare relative to its weight in our portfolios.
4. Management decisions may become questionable, influenced by perceptions of terminal value risk.

The challenge we face with Dropbox, as it relates to terminal value risk, is that the company is no longer growing, yet management continues to allocate resources to R&D as though growth were imminent. One quote from the Q1 2024 Dropbox earnings call stood out as particularly frustrating in this regard:

A lot of the road that we're on is reminiscent to me of Netflix, 10, 20 years ago, right? They started out with a vision of like, you should just be able to play, just help me press play on anything I want to watch. That value prop has stayed the same, but the way they deliver the service obviously changed a lot. I mean, initially they were mailing you DVDs, but then as they went to streaming and the world since broadband penetration and everything else became kind of ready for that. All the way they delivered the service changed massively, but the value prop didn't and the whole DVD mailing base eventually, or they helped bootstrap the streaming business and made this seamless transition throughout.

And so I think there are a lot of parallels in that for us. I mean, I think one difference is DVDs kind of did go away. Files are not going away, so it's more thinking about working back from like what is that kind of idealized content experience and building towards that in addition to optimizing the FSS business, in addition to building Dash, but we think there's an exciting overlap and convergence there. – Drew Houston

This is a clear example of “survivorship bias.” As Wikipedia defines it, survivorship bias is “the logical error of concentrating on entities that passed a selection process while overlooking those that did not.”² Netflix is an outlier—far more companies failed along the way. Meanwhile, Dropbox has pursued efforts like Paper, Dropbox Spaces, and now Dropbox Dash. One could fault us for failing to fully appreciate these challenges upfront, and we think such questions are fair; however, this issue became increasingly evident as we progressed further into our original DCF analysis over time.

Moreover, at times, we anticipated Dropbox might adopt a more aggressive approach to acquisitions and tuck-ins, like HelloSign and Docsend, to target interesting adjacencies. Unfortunately, these moves appear more tangential than central to a strategy of reigniting meaningful growth. While we hope we are wrong—and we remain happy customers—we felt it was imperative to step to the sidelines, with the potential to re-underwrite an investment from scratch in the future.

2 https://en.wikipedia.org/wiki/Survivorship_bias

NEW BUYS:

During the quarter, we initiated three new investments, each in companies we have followed closely for a considerable time. At various points, we viewed them as missed opportunities; however, our experience with Mr. Market has taught us that patience often creates inevitable entry points. This quarter, some exciting opportunities presented themselves. The three investments are Amazon (NASDAQ: AMZN), Diageo (NYSE: DEO), and Uber (NASDAQ: UBER). We will discuss each in detail below.

Amazon:

Amazon is one of the most widely followed companies in the world. While the “Magnificent 7” (of which Amazon is a key member) is often seen as a runaway freight train, we were able to purchase Amazon shares at prices last seen in 2021—three years ago. How is this possible if the “Mag7” has been so dominant? We believe it largely reflects the increasing prevalence of narratives driving market sentiment.

Another question might be: why has Amazon stagnated over this period while other mega-caps have thrived? We attribute this to two primary headwinds affecting Amazon’s core end markets:

- **E-commerce:** During COVID, when e-commerce sales experienced a step-change upward and were growing at an exponential rate, Amazon invested aggressively in fulfillment center capacity and logistical capabilities ahead of demand. This consumed a significant portion of the business’s cash-generating potential, delaying the realization of efficiencies that a denser network would provide. However, from Amazon’s perspective, this strategy was a long-term play. Eventually, the company would scale into these efficiencies, securing an insurmountable lead over peers in cost per delivery. **As a result, Amazon’s e-commerce segment is arguably the most defensible (or “moated”) business in the world—and perhaps the most underappreciated part of the company.**
- **Software:** AWS has long been the dominant infrastructure-as-a-service (IaaS) platform, benefiting from industry-leading scale and margins. While this remains true, the rise of AI has introduced the first formidable challenge to the business. AWS was originally optimized for a world where CPU dominated, but with the advent of AI, GPUs now reign supreme. In response, Amazon is investing aggressively to adapt its infrastructure to meet the demands of AI while maintaining its leadership in IaaS.

The timing of waning e-commerce investment intensity coinciding with AWS’s need for further CAPEX investment is remarkably fortuitous for Amazon. Amidst this shift, free cash flow has been ramping aggressively throughout 2024 and is set to continue growing beyond. We find this to be an especially compelling and timely investment, given the rapid acceleration in free cash flow underway. From 2024 to 2026, we expect free cash flow to more than double. At the time of our entry, we effectively purchased Amazon at a 4.5% free cash flow yield based on our 2026 expectations—at a point where free cash flow should continue growing well into the double digits.

Another way to frame our entry is that we acquired Amazon at 30x AWS EBITDA, with the most moated business we know—Amazon’s e-commerce segment—essentially included for free. While it’s difficult to determine whether 30x EBITDA is the “right” multiple for AWS, especially given its capital-intensive nature, it seems reasonable for a business growing at nearly 20% annually with margins expanding at a high single-digit rate.

In many ways, we were drawn to Amazon while observing Walmart's P/E multiple climb to 40x and Costco's approach 50x on a forward basis. By comparison, Amazon, trading at a multiple in the low 30s, arguably offers a stronger moat in retail and exceptional growth at scale in its software business—suggesting it should command investment enthusiasm on par with these giants. Costco's membership model, after all, bears a strong resemblance to Amazon Prime. If we were to apply Costco's EBITDA multiple to Amazon's e-commerce business, the implied value of AWS would be negative \$300 billion at our cost basis. Yes, you read that correctly—negative \$300 billion! While we believe Costco's multiple is likely too high to generate attractive returns over the coming years, this comparison underscores just how compelling Amazon's valuation is today.

Diageo:

COVID was a bonanza for spirits companies, but the aftermath has proven challenging. The retail channel became over-inventoried, and as the on-trade (industry lingo for restaurants and bars) restocked their shelves and consumers returned to in-person gatherings, tough comparables led to slower growth rates—or even declines. In the stock market, Diageo serves as the bellwether for the spirits industry, and its woes began with questions about when the industry might return to growth. These challenges have since been compounded by a series of emergent narratives that weigh heavily on the stock today. These narratives include, but are not limited to, concerns about GLP-1 drugs altering behavior, Gen Z imbibing less than prior generations, economic struggles in emerging markets like Latin America and China, and fears of harsher regulations and warnings for the industry.

It's always fascinating to observe how justifiably poor stock performance can evolve into narratives that assume perpetual decline. Notably, the worst-performing region for Diageo was Latin America, where sales declined over 20% year-over-year—despite the fact that many of these broader narrative forces are not meaningfully present in the region.

We have long admired Diageo for its broad portfolio, which is well-positioned to capitalize on the best trends within the alcohol industry. However, we've been reluctant to pay prevailing market multiples for the stock. At the time of our purchase, Diageo was on the verge of closing out a third consecutive year of 20% stock market declines. **With the S&P 500 rising over this period, Diageo's valuation relative to the index fell to its lowest level ever.**

We believe 2024's market struggles were amplified by the company's UK domicile, as the UK stock market—arguably the worst-performing developed market in the world—suffered from significant outflows. It's easy to see how a combination of a high starting valuation, tough comparables, and a snowballing narrative of negativity contributed to Diageo's challenges. However, on the other side of this rough patch, one can equally appreciate the setup for much stronger returns going forward.

Even amidst the challenges facing the spirits industry, Diageo remains the best house in a bad neighborhood—a crucial starting point. Among the large spirits companies, Diageo has the greatest exposure to tequila, the one spirit category that drives growth for the entire industry.³

3 <https://nielseniq.com/wp-content/uploads/sites/4/2025/01/NIQ-BevAl-2024-Year-in-Review.pdf>

Spirits-based RTDs and Tequila driving majority of growth for Spirits in 2024

2024 Off-premise Spirits up +0.2% vs 2023

Spirits segments – Contribution to dollar sales (in millions)
NIQ off-premise channels



Source: NIQ Scan Off-Premise Channels (eAOC+Conv+Liquor Open State), Diageo Integrated Beer, Wine, & Spirits database. Latest 12 weeks ending 12/28/2024 vs. year ago



*All other includes Grain Alc, Japanese Whiskey, and Other Whiskey

Diageo famously acquired George Clooney’s Casamigos and transformed it into one of the world’s premier tequila brands. While the company may have pushed prices too aggressively in recent years, it benefits from the portfolio effect: Don Julio effectively captures any lost market share from price-sensitive Casamigos drinkers. Don Julio has also leveraged this increased demand to launch its first reposado, further fueling growth in the category.

One of the more fascinating dynamics in the spirits industry is the agave market, which we have been closely following. As tequila’s popularity soared, agave supplies became incredibly tight, compressing margins and cash flow for tequila producers. However, after years of planting to meet demand, agave supplies now exceed demand, causing prices to collapse. The immediate impact of this is a rapid improvement in tequila margins for Diageo.

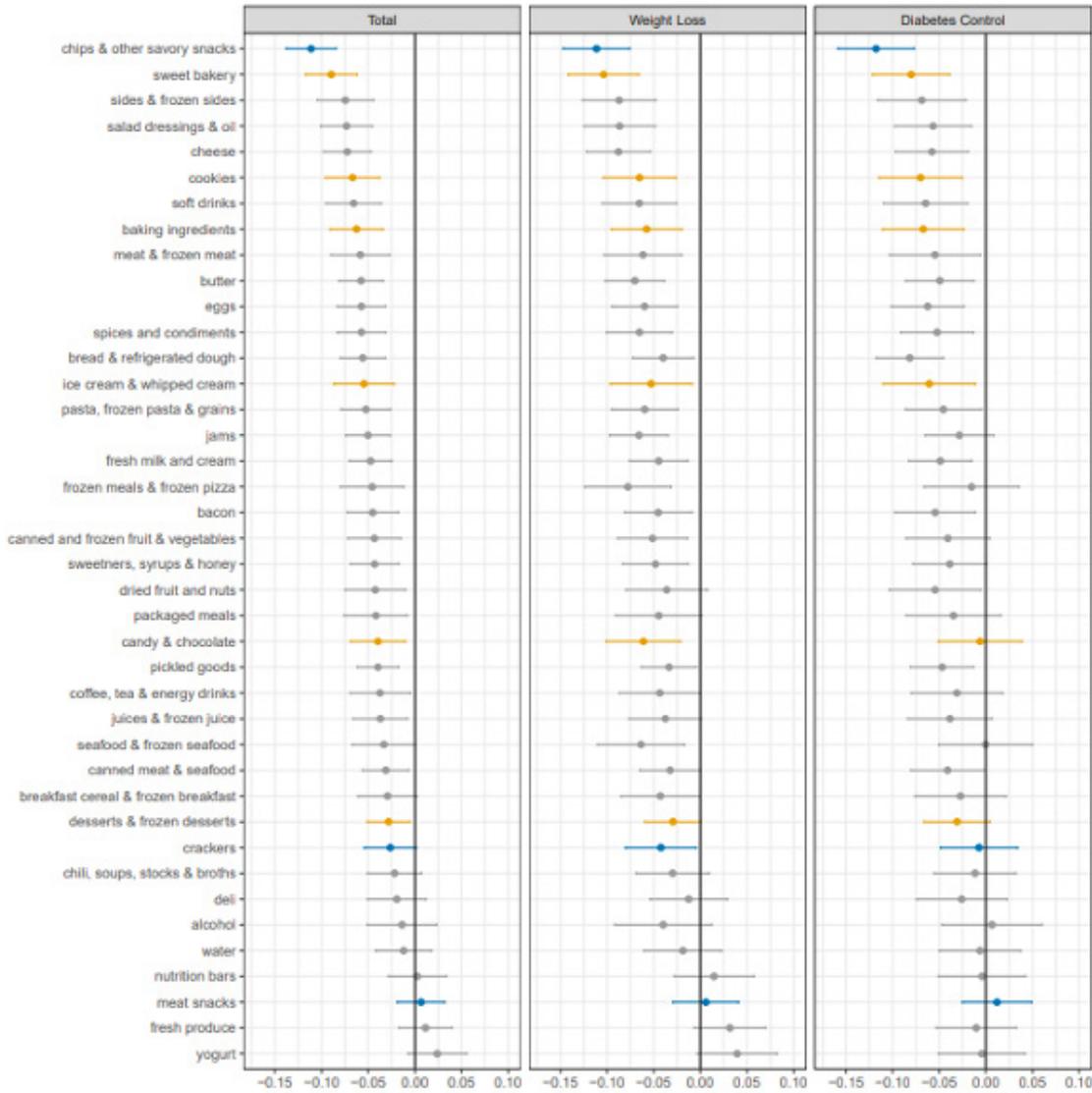
The second-order effect is equally compelling. During the supply shortage, Diageo prioritized the U.S. market, where tequila growth was robust, and largely avoided pushing supply into Europe, where tequila had little heritage. With agave supply now more readily available, Diageo has been able to drive significant growth in the European market. We believe tequila is poised to take meaningful market share from gin and vodka in Europe, potentially sparking a second wave of global growth—even as growth rates in the U.S. begin to moderate.

Beyond tequila, Diageo owns Guinness, which accounts for a high single-digit percentage of its sales. Guinness is currently experiencing a surge in viral popularity, with demand outpacing supply and causing shortages in key markets. Importantly, the brand is also thriving in the no-alcohol segment. As one of the most flavorful global beer brands, Guinness has become a go-to option for consumers looking to limit their alcohol intake while still enjoying the taste and experience of a premium beverage.

Between tequila and Guinness, we see a clear path for Diageo to outgrow the broader industry in the coming years. Importantly, we believe the negative narrative surrounding alcohol carries more weight in

headlines than it does in the actual numbers. Inventory headwinds have exaggerated these narratives, making them appear more significant than they truly are. Alcohol has been a staple for millennia, and that is unlikely to change now. While GLP-1 drugs undoubtedly have an impact, the effect on alcohol consumption appears far smaller compared to other food and beverage categories.⁴

Figure 7: Changes in Grocery Spending Six Months Post GLP-1 Adoption by Category



Notes: Estimates of changes in shopping patterns for the 6-month period post-adoption for 40 top grocery categories. X-axis represents the estimated changes using TWFE (multiplying the estimate by 100 gives the approximate percentage change). Categories are sorted based on the magnitude of the parameter estimate. Blue estimates represent categories corresponding to Savory Snacks, while Yellow estimates represent categories corresponding to Sweets. Estimates are based on 2,623 users and 4,072 corresponding matched non-adopters. Standard errors are clustered at the household level.

We also believe Gen Z's long-term behaviors are far less certain than the prevailing narrative suggests. This generation came of age during COVID lockdowns and restrictions, which shaped their high school and early college experiences, and they are the first fully native smartphone generation. These factors made obtaining and consuming alcohol more challenging compared to prior generations. For instance, we recall that in college, nearly every student had a fake ID—even in the wake of 9/11—but today, advancements in technology have made this nearly impossible. While this isn't necessarily a negative development, it does create an apples-to-oranges comparison when evaluating Gen Z's behaviors in their early 20s against those of previous generations.

4 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=5073929

Diageo now trades at approximately 15x earnings, its lowest multiple since the aftermath of the financial crisis. This valuation comes as growth is on the verge of reaccelerating—a trend we expect to begin in 2025 and gain momentum in 2026. Additionally, Diageo's margins have been under pressure as growth has lagged expectations. However, we believe the company has an opportunity to improve operating margins by at least 2 percentage points, if not more, through a combination of efficiency initiatives and renewed growth.

With investments in CAPEX and inventory tapering off significantly, we anticipate free cash flow to jump by over 20% in the current fiscal year, resulting in a free cash flow yield of 4.7%. Looking ahead, we expect free cash flow to grow well beyond revenue, with a path to a free cash flow yield of nearly 6% on our cost basis within two years. Meanwhile, as a high-ROE company, Diageo can continue to grow while paying out a dividend yield of 3.5%. In today's environment, we find this combination of growth, cash flow, and yield incredibly compelling.

Uber:

At the halfway point of the year, Uber was one of the top-performing stocks in the S&P, and we couldn't help but kick ourselves for having spent considerable time researching the company—demonstrating genuine interest—only to never invest a dime. By year-end, however, Uber's stock had not only surrendered all its gains but had fallen even further. So, what changed? Hype, plain and simple. Specifically, hype surrounding fully autonomous vehicles (AVs).

While we are excited by the advancements toward full autonomy and have friends who rave about their experiences with Waymo, the narrative (there's that word again!) surrounding the inevitability of AVs has become so pervasive that it's taken on a life of its own in markets.

There are essentially two ways to express a belief in the inevitability of autonomous vehicles (AVs) via stocks: buying Tesla or shorting Uber/Lyft. This dynamic was evident immediately after the election, when Tesla's stock went parabolic, and Uber's collapsed on the assumption that Elon Musk's close relationship with President Trump would drastically reduce regulatory barriers for broader AV adoption. Leaving aside the fact that this technology is not yet ready for universal deployment across the U.S., we believe Uber's stock is the wrong way to express this opinion in public markets. In fact, Uber could ultimately stand to benefit from the proliferation of AVs.

Before delving deeper, let's establish a few facts about the current AV landscape. Today, AVs are operational only in specific climates and geographies, under certain weather conditions, and are regulatorily approved only in confined areas within cities. Despite these limitations, Uber is the aggregator of choice in many of these locations. Given the very real constraints of AVs today, it is nearly impossible to replace a large-scale network of human drivers with a single app that aggregates global demand. This is precisely why Waymo has relied on Uber in several key geographies. AVs can serve as an important source of supply, but their capacity must flex alongside peaks and troughs in demand—something Uber's network is uniquely positioned to manage.

Amidst the backdrop of AV-related fears, Uber's stock now reflects some fairly draconian assumptions. In 2024, Uber is expected to generate approximately \$6.5 billion in free cash flow, growing to over \$8 billion

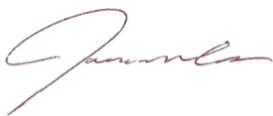
in 2025—equating to a free cash flow yield of 4.8% and 6%, respectively. The majority of this cash is being allocated toward share repurchases. Over the next five years—a time frame within which universal AV deployment remains highly optimistic—Uber could potentially return nearly half of its market cap in cash to shareholders while significantly shrinking its share count.

The current terminal value of Uber effectively prices in a high likelihood that the business will cease to operate as it does today. We believe this is a misguided assumption, especially given that approximately one-quarter of Uber's EBITDA comes from Uber Eats—a business far less vulnerable to AV disruption. In fact, if AV technology were deployed for food delivery (e.g., small autonomous robots instead of cars), it could significantly enhance EBITDA margins.

Moreover, if we applied DoorDash's multiple to Uber Eats, the implied valuation of the rideshare business would be roughly 4.8x on 2025 EBITDA estimates. Whichever way you look at it, Uber appears deeply undervalued today, and we're excited to have been given a second opportunity to acquire shares at these levels.

Thank you for your trust and confidence, and for selecting us to be your advisor of choice. Please call us directly to discuss this commentary in more detail – we are always happy to address any specific questions you may have. You can reach Jason or Elliot directly at 516-665-1945. Alternatively, we've included our direct dial numbers with our names below.

Warm personal regards,



Jason Gilbert, CPA/PFS, CFF, CGMA
Managing Partner, President

O: (516) 665-1945

D: (516) 665-1940

M: (917) 536-3066

jason@rgaia.com

 [@jasonmgilbert](https://twitter.com/jasonmgilbert)



Elliot Turner, CFA
Managing Partner, CIO

O: (516) 665-1945

D: (516) 665-1942

M: (516) 729-5174

elliott@rgaia.com

 [@elliottturn](https://twitter.com/elliottturn)