2025 Market Recap and Year-End Portfolio Management Strategies

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David Hagee: Hello and welcome to Conversations with Commerce Trust, our show about the markets, investment themes and economic insights that matter to you. I'm your host, David Hagee, Chief Investment Officer with Commerce Trust.

Today, our Director of Family Wealth Strategies, Kelly Jernigan, joins me to discuss portfolio management, tax implications, and strategies to close out the year. Welcome back to the podcast, Kelly.

Kelly Jernigan: Thanks, David. Great to be back on.

David: Great to have you back on, but we've had a great year inside the markets. You know, this year following up to over 20% returns for the S&P 500 (Index). As we sit today about mid-November, the S&P 500 is up about 15%-ish.

The market has been led by the NASDAQ (Composite Index), so the tech-heavy NASDAQ up about 19% at this point and so a really strong year. Any other sort of areas of note that you've been thinking about, Kelly?

Kelly: Well, sure. Really, I've been thinking about you know the tension and the back and forth that we've seen in the markets this year. You know we did start off if you looked at the beginning of the year to now you wouldn't think anything happened in the middle other than the Mag Seven (Magnificent Seven stocks) and you know driving returns, right? Having those tech-heavy AI (artificial intelligence), you know, returns in the markets.

But as you and I both know, you know, April we saw a pullback in the markets and we do expect pullbacks from time to time, but that was based around tariff announcements. We also had geopolitical risks as well. There's a lot of attention on Houthis and, you know, the Red Sea and supply chain as well as the bombing of Iran during the summer and then of course, you know, continued geopolitical tension. You know, Russia-Ukraine, you know, Israel and Gaza.

So it's certainly not a clear story from beginning to end. There's been a lot of volatility and concern and worry throughout the year, but yet we continue to have economic and market growth.

David: Yeah, no doubt about it. This year we've seen a tremendous amount of geopolitical tensions in place. While the market has been much more earnings focused, if I look at valuations, I think some context is helpful here. We are at a higher valuation than our historical averages. We're roughly about 22, 23 times earnings on the S&P 500. Historically we're around 18 times is the longer-term average.

But interestingly enough, in the tech period at the turn of the century, in the late 90s (1990s) and into 2000, those valuations were well into the 30 times earning area. I'm struck this year that really we haven't seen a valuation expansion, right? People aren't paying more for earnings, but we've seen that earnings growth. Kelly, any thoughts on valuations?

Kelly: Well, absolutely. Certainly, there's been talk and you do have the fear-mongering right that, is this a bubble, are we in in 2000? But David, as you mentioned, earnings continue to drive growth. And we're very positive on earnings and on equities. And we've certainly seen, you know, this quarter, you know if you miss earnings you're going to get punished. But if you beat expectations then the market's going to reward you.

We still think that equities are going to be positive. We've seen of course, as you have said, the S&P has returned 15% so far year-to-date. International equities which have been weak have seen some strength. Now again talk about difference. You know at beginning of the year the dollar was very strong but really coming off of a peak.

It dropped more than 10% which of course helped international returns and then it's really kind of bounced back a little bit and trading in the channel which has been positive. So when looking at those valuations there certainly is support for continued market expansion.

David: And as we think about where that earnings growth has come from, I think the story of all stories, at least for investors, inside 2025 has been AI. AI is everywhere and it is everything if you listen to the earnings calls going on right now for third quarter earnings.

I think it's a standing bet that you'll hear at least 10 AI mentions for companies that you wouldn't normally think associate with AI. So yeah, any other themes or any expansion on that AI theme that we've been, we've been experiencing for the year?

Kelly: Well, one of the themes that we've seen is, and again this goes to the tension that we've seen, is that you see a weakening job market. You know, you've seen a number of firms announce layoffs, Verizon (Verizon Communications Inc.) for example recently, but then they cite AI as an example.

So even though you have weak job numbers, you could have productivity expansion, which would again offset any sort of loss you have from jobs because of continued economic growth. So, I know we've started to adopt more AI here at Commerce Trust. And so, if AI improves productivity, then again you're going to see a stronger economic growth and companies that use it wisely be rewarded in the marketplace.

David: So as we sit today, we're sort of at, maybe not a crossroads, but you mentioned tension that we do have, continuing to have, strong growth inside the U.S., but there's also some conflicting information out there.

It would appear, even though we're at a deficit of government data at this point, that the jobs market is slowing materially. And that, you know, the full impact from tariffs on inflation is yet to be totally digested inside our inflation numbers. You know, as we look forward into 2026, what are your thoughts on the U.S. economy?

Kelly: Well, I think the great story of 2025 is tariffs. And really, you haven't seen tariffs come through the inflation numbers like we expected or certainly like, you know, most economists thought would hit. And when I've talked to people in the C-suite, CEOs, again, they're not hiring, they're keeping powder dry, but they also have projects lined up for the go in 2026.

In part, because of again, getting back to that theme of tension, the tension that you've had in Washington (D.C.), the uncertainty around tariffs, you certainly see tariffs being negotiated and coming down from what was announced in April.

So, it does set up for economic growth in 2026 and certainly pronouncements of recession have been, you know, possibly overstated. And certainly, we don't see that on the horizon and you know either through the end of the year or in beginning of 2026 either.

David: And then any thoughts for sort of headwinds that the market may be facing, or the economy may be facing for ’26 (2026)?

Kelly: So, a couple of headwinds. Again, you know, one thing that we're looking at is jobs. And if those continue to deteriorate and offset any productivity gains, that would be certainly a concern. Housing market is something that we're looking carefully at.

And then again, the consumer, right? Everything in the U.S. comes back to the consumer. Consumers are concerned about inflation, about the cost of goods, about the jobs market, about housing. And so, you could have, essentially a self-fulfilling prophecy, right?

If people, things are going to be bad and they're acting like things are bad, then do things turn out to slow down growth. So those are probably the three greatest headwinds we have are if you have continuing weakening job numbers, if the housing market, you know, continues to decline, and then the consumer, you know, really creates this self-fulfilling prophecy and drags the economy down with it.

David: So, for most people, the holidays is an especially busy time as we look to close out the year. For portfolio managers, this is twofold. This tends to be our most active point in the year on a regular basis.

And the reason is, is that, you know, taxes close out at the end of the calendar year of course. So, as we're thinking about that, I think it's a very helpful time to kind of review strategies. If I'm looking at the just the S&P 500 since the end of 2022 when we had a pretty challenging year, pretty tough year out there. The market is up just on a price basis about 78%. If you have dividends reinvested in the index, it's up about 85% cumulatively. So, there's a lot of capital gains out there, whether they're embedded inside mutual funds or whether in inside the individual stocks.

Maybe we can talk for a minute about some strategies in place to be able to mitigate some of those gains to make sure our portfolios stay aligned with our asset allocation. As we talk about that, maybe we could start in with the most common tax loss harvesting. Would you mind spending a minute on that?

Kelly: Yeah, of course. So, tax loss harvesting is where you take stocks or mutual funds that have losses for the year and you sell those and you either buy something that is like that security or you simply, you know, maybe park it in cash and then reinvest it in 30 days, 31 days to establish a new price. And in a market where there is volatility like there has been there are some opportunities.

Now of course you know you're not going to sell the Mag Seven because there's a lot of gains in that, but there may be some stocks that have fallen and so you can take those losses for example. Another thing that we look at as portfolio managers, and our research group does a phenomenal job of letting us know if we are holding mutual funds, are they going to pass through capital gains so that we're well aware of that and can take advantage of maybe selling those positions. Reducing those positions before the gains hit or simply just being aware of those gains for our clients.

And then another thing that portfolio managers keep in mind is that if we are creating capital gains, making sure we're not pushing our clients into a higher tax bracket. So that's another thing that portfolio managers have to think about, but there's other ways to take advantage of gains in portfolios as well. Such as if you do have an appreciated stock like NVIDIA (NVIDIA Corporation), there's gifting strategies where that that can be used as well, David.

David: Yeah, I think that's a great segue into the other aspect here is that whether it's gifting into some sort of broader estate plan or just the in general gifting that you do to children, this is a great way to pass gains off. Of course you don't get rid of them, they become somebody else's problem, but maybe it's a way to start mitigating.

You know, as we talk about gifting, I think philanthropy as is a place in the conversation as well. As we're looking, you know there's a couple of different strategies out there. There's donor-advised funds as well as just flat out doing your gifting to whatever 501(c)(3) that you're giving to. In appreciated securities, maybe we could walk through that strategy a little bit.

Kelly: Sure. So you know, if you have an appreciated stock in a portfolio, gift that stock to your donor-advised fund or directly to a charity. They don't take the capital gains on it, right? So you can immediately sell that.

If you have cash on hand, then you know you can donate that cash or give that cash back to your investment account so we can reestablish the position. You know, that way you have a higher cost basis, right, a higher price that you've paid, but then you still own the stock like NVIDIA.

Another tax efficient gifting method for those who are 70 1/2 years of age or older, could be to make a qualified charitable distribution directly from your IRA to a qualified charity. Such distributions up to a certain amount each year are not included in the donor's taxable income. So that's another gifting strategy that you might use to your advantage.

David: Yeah, for as simple as those strategies are, I think it's a very powerful strategy for philanthropy that you're already doing rather than using cash to use appreciated securities. Whenever the gift is made, it's made at the market value of the security, not your cost basis.

And so if you were to give away something with a $10 cost basis, but it's worth $100, the charity receives the full $100, you get the deduction of $100 and you don't pay the $90 in capital gains. So it's a very straightforward but very powerful strategy.

I think the context of all this tax management that we're talking about is steering us back to what we view as the vital question and Kelly, you chair our Investment Policy Committee. Talking about asset allocation and repositioning and de-risking. Maybe we could spend a little bit of time around asset allocation. I think this is the cornerstone of all of our portfolio management here.

Kelly: Well, as you know, David, asset allocation really drives investor returns. And so, it's important really, you know, at the end of the year when we have had gains, you know, of 15% in the S&P and you've had gains in in international, looking through the portfolio and making sure that your asset allocation is in line with your risk tolerance. Is in line with your investment objectives and goals that if you do have cash flow needs that you have sufficient cash on hand.

And so the end of the year is a great time to take a look at asset allocation and rebalance.

David: Yeah, you know, as I look at things, it's easy for us to be able to ride this AI wave and have a very concentrated position out there in some of these Mag Seven stocks or AI related stocks out there. But also, you know we have to understand too what that does to a portfolio, right, that now you're much more dependent on several names.

So doing a little bit of de-risking inside the portfolio of just reducing concentrated positions, whether that means taking capital gains or exercising one of the tax strategies we talked about, can be an effective way of just lowering the overall risk inside of a portfolio. And I think that over longer term that's going to lead to strong results for you.

As if this is an AI boom or a bubble, nobody knows at this point, but certainly by taking gains, especially as I mentioned earlier when we're up about 85% from the end of 2022 is never a bad thing. And oftentimes, as you mentioned earlier, if you have some cash, you can start to reset some cost basis by paying the capital gains and getting a higher cost basis in there.

Thanks for the interesting discussion today, Kelly.

Kelly: Thanks for having me on, David. Appreciate the opportunity.

David: For more on this topic, please visit www.commercetrustcompany.com for additional commentary and our Outlook. If you've enjoyed what you've heard, you can subscribe to our show on Apple Podcasts, Spotify, Amazon Music, or wherever you get your podcasts from.

Thank you for joining us on Conversations with Commerce Trust. I'm David Hagee. We'll talk again soon.

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