

July 25, 2025

Dear Clients and Partners:

The markets closed out the second quarter of 2025 strong after a poor Q1 and a very bad start to the quarter. Below we show the first quarter and first half results by size and strategy. It was quite a turn-around not just for the full quarter but intra-quarter where we came within 1% of having a bear market (20% market decline peak to trough):

First Quarter 2025			First Half 2025				
	Value	Blend	Growth		Value	Blend	Growth
Large	2.1%	-4.3%	-10.0%	Large	6.0%	6.2%	6.1%
Mid	-2.1%	-3.4%	-7.1%	Mid	3.1%	4.8%	9.8%
Small	-7.7%	-9.5%	-11.1%	Small	-3.2%	-1.8%	-0.5%

Source: JP Morgan

We are going to include some of the first quarter 2025 commentary here because it is so instructive of how the markets work and behave:

1Q25 was effectively an exact flip of 4Q24. This quarter Value dominated, especially Large Cap Value. Growth performed poorly with Mid Caps doing the best of them all. This quarter, Small Caps continued their underperformance. In reality, this was a Mega Cap sell-off after a fantastic run. Let's look at this closer.

1Q25 Results in Detail

Under the hood of the S&P500 there are 11 sectors. Of those sectors, only four ended the quarter in the red and two of the four (Industrials and Communications) declined less than 1%. As a result only two sectors really led this sell-off, Technology and Consumer Discretionary.

Effectively, this was a Large Cap tech driven pullback. The predominant theory for the pullback is that the “AI trade” is over. We do not know what will happen regarding the “AI trade” but AI is coming, and it is coming fast. This is truly transformative technology for anyone that has utilized it.

Zooming out it is worth looking at (i) the primary Large Cap AI companies and their performance since November 30th, 2022, the date of ChatGPT’s launch and (ii) the pullbacks since their stock prices peaked:

	11/30/2022	Current	% Change		Peak	Current	% Change
Semis				Semis			
NVDA	17	110	549%	NVDA	149	110	-27%
AVGO	52	168	223%	AVGO	250	168	-33%
Mega-Cap Tech				Mega-Cap Tech			
MSFT	254	382	50%	MSFT	468	382	-18%
GOOG	95	160	68%	GOOG	208	160	-23%
AMZN	92	193	110%	AMZN	242	193	-20%

The conclusions here are relatively straightforward. Growth, especially the AI trade, had a fantastic run. Trillions of dollars were created. The stocks themselves got ahead of the business valuations and traded back down towards more reasonable levels. This is how the markets have always worked and always will since the markets are still driven by human beings and that involves a lot of emotions.

What happens next is the key question. Generally, there are two options: (i) the companies’ earnings continue to grow and the stocks follow or (ii) the earnings were largely overstated, and the stocks will need to trade to a reasonable figure on the new earnings / growth expectations.

When it comes to AI, we remain fully in the first camp. The speed of this revolution is very real. The use cases are expanding rapidly. The valuations of the primary companies are very reasonable, if not cheap. It is a reasonable argument that the “easy money has been made” but we continue to believe that this is short-sighted. This is very likely to change the world in exciting and scary ways. These companies will benefit massively.

What happened next was that earnings were fantastic, and it became clear that not only is the AI trade not over...it is likely still early. That seems somewhat hard to comprehend because these stocks have already done so well but this is not an incremental or sustaining type of technology, this is truly transformational. This transformation is driving massive earnings growth for the companies involved, in most cases justifying the significant increases in share prices.

For fun, we decided to see how the AI would do with updating the above table for 2Q25 returns. Normally, we would simply use Excel plug-ins from Bloomberg as those work perfectly so this is not a “transformative AI moment” but it is worth discussing.

Our first attempt using GPT 4o shows the limits of AI currently. After 4 attempts requesting the market returns for each stock noted above this is what we received:

✓ Summary Table (estimates)

Ticker	Estimated Q2 '25 Total Return
NVDA	+8% to +10%
AVGO	-1% to +1%
MSFT	+5% to +7%
GOOG	+4% to +6%
AMZN	+2% to +4%

This is wrong and an example of how you cannot simply trust the AI and move on. So, we switched over to the reasoning model o4mini and input the same prompt. The reasoning model took about 15 seconds and got it perfect:

📄 Q2 2025 Total Returns (Price + Dividends)

Ticker	Price Return (3/31–6/30)	Dividends Paid in Q2	Estimated Total Return
NVDA	+45.8%	\$0.01/share ≈ +0.01% 🌞	+45.8% (dividend negligible)
AVGO	+64.6%	\$0.59/share ≈ +0.21%	+64.8%
MSFT	+32.7%	~\$0.75/share ≈ +0.15%	+32.9%
GOOG	+13.5%	None	+13.5%
AMZN	+15.3%	None	+15.3%

This of course is no big deal in terms of functionality. There are a million other tools that could have done the same thing for us. However, watching the reasoning of the models is truly something to behold.

As it thought through exactly what we asked it to do (it shows the reasoning) it was going through each step as a beginning staff person would. When it got to the time period, it thought through “is it referring to the companies’ fiscal or calendar years...it appears it is looking for calendar periods”. This is something that we have seen myriad young employees make mistakes on over the years. Usually, they don’t even take the time to think about that, but the AI thought through it and got it right.

Finally, as we look back at the first half performance it jumps out that Small Caps once again significantly underperformed. Given that this is our job, we understand why that is but would the AI understand a lot of the implications if we asked it? So we asked o4-mini for an explanation. Here is the response:

Thought for 4 seconds ▾

- The user is asking why small-cap stocks are performing poorly compared to large-cap ones. I can answer using what I know: rising interest rates, higher costs of capital, economic slowdowns, and investor preference for stability. Small caps are particularly vulnerable to these factors, as well as exposure to riskier sectors. In Q2 2025, big tech and AI stocks are driving large-cap growth, while small caps face challenges like higher borrowing costs and lower profitability. I'll search recent finance articles to support this.

🌐 Searched the web

🔍 Why are small caps underperforming large caps Q2 2025 reasons

🔴 moneyweek.com 🔴 www.marketwatch.com 🔴 www.businessinsider.com 🔴 10 more

- Small caps tend to underperform for several reasons. They're highly sensitive to interest rates

👌 Done

Small-cap stocks have lagged large-caps over Q2 (and more broadly) for several interrelated reasons:

1. Higher Interest-Rate Sensitivity

Smaller companies tend to rely more heavily on external financing—and at higher rates—than large issuers. With the Fed holding policy rates elevated into mid-2025, borrowing costs have risen, squeezing small-cap earnings and growth prospects more than those of large-caps, which can tap cheaper, longer-dated debt or fund operations from cash reserves [schwab.com](#).

2. Greater Economic Cyclicalities

Small-cap firms are often concentrated in economically sensitive sectors (industrial suppliers, regional services, consumer discretionary) and thus underperform when growth slows. In a late-cycle environment—when recession fears mount and cap-ex plans get deferred—small caps typically take the brunt of the sell-off, while large-caps (especially defensive or secular-growth names) hold up better [wellington.com](#).

3. Index Concentration in Big Tech

Large-cap benchmarks (like the S&P 500) are dominated by a handful of “Magnificent Seven” tech giants—AWS, Microsoft, Alphabet, NVIDIA, etc.—which have delivered outsized returns on AI and cloud themes. That concentration has lifted cap-weighted indices even as broader small-cap universes remain flat or negative. In essence, large-cap “winners” have masked the underperformance of the rest of the market.

4. Valuation and Quality Divergence

A decade of subpar small-cap returns has left valuations near multi-year lows versus large-caps. At the same time, some of the higher-quality small-cap companies have been taken private by private-equity buyers, leaving a public small-cap cohort with weaker fundamentals. That dynamic forces investors to demand even steeper discounts before allocating capital back to the space [acadian-asset.com](#).

5. Liquidity and Trading Costs

Smaller market-cap stocks trade less frequently and in lower volumes, making them more vulnerable to large swings on flow imbalances. In choppy markets, institutions often prefer the tighter bid-ask spreads and deeper liquidity of large-caps, exacerbating small-cap sell-pressure.

The reasoning process was interesting. It “knows the general concepts” and then it went to the web to find support for these. We would take some exception with the links it chose to use to support this but the general reasoning for this is pretty spot on and very impressive. This is still relatively basic knowledge but impressive nonetheless.

While our use cases discussed above are basic and somewhat mundane, the stories that we read about Cursor coding, AI video generation, etc. are truly impressive. Our best guess is that there are going to be a lot of fits and starts along this process.

The Bill Gates saying is likely appropriate here: “We always overestimate the change that will occur in the next two years and underestimate the change that will occur in the next ten.” No one knows when we will achieve AGI and even the definition of it keeps changing and/or adding in new vocabulary such as Super Intelligence.

Maybe the best definition comes from the current Microsoft CEO Satya Nadella:

“Us self-claiming some AGI milestone, that’s just nonsensical benchmark hacking.

The real benchmark is: the world growing at 10 percent, seven percent for the developed world— inflation-adjusted growing at five percent—that’s the true marker.

When we say ‘Oh, this is like the Industrial Revolution,’ let’s have that Industrial Revolution-type of growth. Suddenly productivity goes up and the economy is growing at a faster rate. When that happens, we’ll be fine as an industry.”

In other words, let’s see the AI really flow through the economy and create the productivity gains we need to improve human lives at scale. Needless to say, 5% real growth would be a game changer.

Other 2Q Events

Tariffs

Outside of AI, a lot has happened in the last 90 days. Tariffs were paused and we are now getting some outcomes. Last quarter we said:

Where we go from here is anyone’s guess. The bull case is that the President negotiates tariffs down to zero both for us and our trading partners and we actually have increased global trade. His Administration is very focused on trade deficits. Many of the trade deficits are impossible to remedy because many countries cannot afford a lot of our primary exports which are very expensive vs. the cost of living in those countries. However, our larger trading partners (EU, Japan, etc.) can buy large quantities of goods from us to lower the deficit similar to how China previously negotiated lower tariffs by agreeing (open question as to whether they did) to buy large amounts of soybeans, etc. from us. If we can lower trade barriers between the US and our trading partners and have them buy more of our products this could end up positive.

This did not happen but what we said below did:

To summarize, we would expect some deals, likely with a large trading partner first that provides a framework followed by a grand Chinese summit. We have no idea, nor does anyone else, of the damage done thus far to the economy. It is not a trivial figure, but assuming a reasonable outcome in the next 90 days it will be a short-term growth slowdown (potentially similar to 2022) not a disaster longer-term.

We got the UK trade deal, then the China trade deal, and now we will find out about the rest of them. The economy thus far has held in as well.

One Big Beautiful Bill (OB BB)

Congress was able to pass the OB BB. We have been and will continue to be sending out notes regarding this. The bet the Administration is making with this bill is that economic growth will offset the deficit. Only time will tell regarding this, but it is not a small bet being made. The deficit is real, and it is not to be taken lightly.

In terms of growth, our “bet” would be that that tax cuts (many of which are extensions for cuts already in place) are not nearly as important as removing unnecessary red-tape and allowing the US to “build again”. The US needs a lot of things but mainly we need the ability to build, whether it is power stations, infrastructure or anything else. For anyone who has done a home remodel, it is clear that the regulations in place, and this is state/county/city specific, can be onerous. Regulation is important but having the government as a partner vs. an adversary in terms of growth is critical no matter whether it is a Republican or Democratic administration.

Conclusion

This quarter felt like the phrase of “There are years where nothing happens, and days where years happen.” It was not as really as dramatic as that but we should not ignore that there were some truly extreme outcomes at play during the quarter which led to very volatile markets.

There are likely to be more extreme outcomes over the coming years as we work through a number of major shifts in politics and technology as a country and a world in general.

As always we are available at your convenience.

Regards,
Your Fortis Team

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