CALLAN

FAMILY OFFICE

1Q25 Investor Letter

Iceberg Principle

In January 2010, Royal Caribbean made a regularly scheduled trip to a resort in Haiti. Yet, this proved to be much more of a calculated risk as they did so after an earthquake hit the island, creating a humanitarian crisis on an epic scale. On the surface, this seemed wildly inappropriate, and the near-term response from the popular press was sharply critical of Royal Caribbean. Yet, the company knew continuing the trip would do more good than harm with Haiti's infrastructure impaired. They were in a unique position to bring necessary food and aid. That most have never heard of this choice to visit the island shows that their risk was the correct move, and the consensus narrative evolved. It also highlights that the correct long-term decision can be in stark contrast to what seems comfortable and appropriate in the short term. This notion is a quintessential dilemma that investors face, and the first quarter of this year has been no exception.

The **Iceberg Principle** suggests it is commonplace to not see all the data relevant to a decision – we see the tip, not the bulk underneath. The early critics of Royal Caribbean displayed the former. The investing environment is no different, including with one of the defining moments this quarter – the DeepSeek saga. The abrupt mainstream emergence of this Chinese tech firm's artificial intelligence (AI) app (DeepSeek-R1) sent shockwaves throughout the tech ecosystem. The crux of the matter was the app reportedly operated at approximately one-tenth the cost of its U.S. peer, ChatGPT. They trained their model on the chips that Nvidia sells and open-sourced how they did it. The instant reaction was that DeepSeek provided the AI community with a blueprint to undercut Nvidia, which accordingly shaved nearly $600 billion in a single day (January 27th) off its market value. The AI narrative, in an instant, was in a tailspin. Or was it?

Few dispute the potential of AI, which is substantial. It could add $17 to $26 trillion in economic activity by unlocking productivity gains and innovation[i]. It is big business, and therefore Nvidia's perceived change in profitability should have coincided with a large loss. This loss happened to be one akin to zeroing out the entire Mexican equity market in a day. Rather, what the DeepSeek theatrics highlighted was a perspective of ours that the innovating, investing, failures, and successes associated with AI would not follow a formulaic or straight-line path. Surprise events happen, testing even those taking calculated risks.

> **"We feel very strongly as a company that the best thing we can do for our relationship with the Haitian people post-earthquake is to bring the ships and supplies and the economic benefit that a ship call represents to the north coast..."**
>
> **- Royal Caribbean's CEO**
>
> **(January 2010)**

As secular growth stories evolve, our approach is to not overreact during the invariable plot twists. Capital can be reallocated in extraordinary fashion in these moments, but this is not a decidedly negative dynamic. All the relevant facts matter. Consider that on January 23rd, just five days prior to the Nvidia sell-off, there was the announcement of a $500 billion syndicate called Stargate, inclusive of Oracle and SoftBank, which would invest in AI infrastructure. Then, 10 days after the Nvidia sell-off, the CEO of Amazon said the following during the company's earnings call:

"On the capex side…. we spent $26.3 billion in capex in Q4. And I think that is reasonably representative of what you could expect in annualized capex rate in 2025. The vast majority of that capex spend is on AI…"

–Andy Jassy (February 6th, 2025)

The combination of just Meta, Amazon, Alphabet and Microsoft plan to invest upwards of $320 billion this year into AI technologies[ii]. A mammoth sum of capital is being infused into the ecosystem. DeepSeek's emergence has not altered this. The volatility exhibited during this saga still had a discomforting element - if you only looked at the tip of the situation.

De-Catastrophizing

Nvidia announced during its fourth quarter earnings call that the company has $43 billion in cash and equivalents with gross margins at +73%. These are staggering numbers. Nonetheless, the stock price and company operating metrics were telling divergent stories this quarter. It is a microcosm of how sentiment can overpower substance, and underscores a key tenet we embrace:

"In investing, what is comfortable is rarely profitable."
–Robert Arnott, founder of Research Affiliates

A critical aspect of the iceberg principle is that when you only see the tip of a situation, assumptions fill in for missing data. As Meg Jay analogized, our smoke-detector minds need to know how to best respond to fires when they surface[iii]. But when we are missing necessary information, fears and facts can be harder to differentiate. Near catastrophes are commonplace, like with Royal Caribbean. Catastrophizing can be too. This has relevancy for navigating the financial markets, as we have been in a string of controversies this year from tariff tensions to AI concerns. Fears are ample, but the fact is the S&P 500 is down 5% this year. We need to be careful to not overreact to this downswing, though, as catastrophizing can create opportunity cost. Tactics exist to help prevent this, and one might seem obvious - de-catastrophizing.

> **"Your brain is like a smoke detector....Your job is to figure out whether the problem is burnt toast, a house fire, or just a false alarm, and respond accordingly."**
>
> **– Meg Jay, clinical psychologist (September 15th, 2020)**

Fixating on what can go wrong has allure. Our primal instincts are to avoid loss, and worrisome items grab our attention. But that something can go wrong does not mean it will go wrong. Frankly, the opposite can hold true. As Scott Galloway highlights in his book, The Algebra of Wealth, there is merit to investing during turbulence. Consider that Microsoft launched during the mid-1970s recession, and the 2008 credit crisis was when Uber and Airbnb started. In recessions, financial capital might be scarcer. However, human capital is typically more plentiful and cheaper, which is what fuels successful startups. So, if 2025 were to take a turn for the worse, we would not see this vintage year as a catastrophe. Rather, we would be inclined to add risk assets, such as venture capital or early-stage investments, as the backdrop should be favorable for the creation of innovative companies. This is the view of someone that de-catastrophizes.

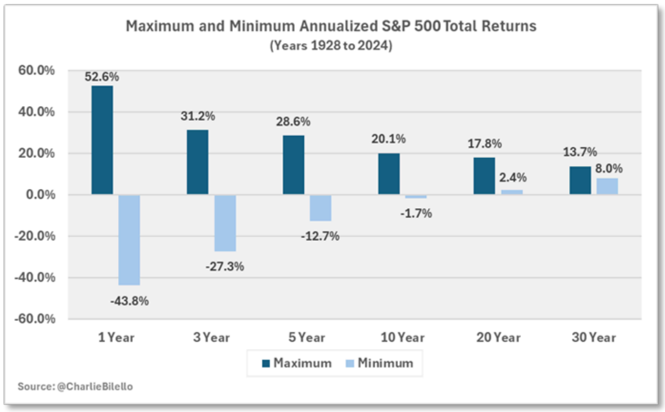
Innovation Arc

Considering a broad, historic perspective is also a way to de-catastrophize situations, including the latest twists in the AI story. Other secular advancements, from cloud computing to the personal computer (PC), provide some clarity on how this growth story will play out. Missteps will occur. Consider the number of PC models that no longer exist from Apple's Lisa to the Macintosh Portable. Gateway might be the most vivid example, as the entire company was discontinued in a stunning fall from grace. It had 7% of the U.S. market share for PCs in 2001 but ceased to exist by 2008[iv]. Even with these failures, we still, of course, use PCs. Mistakes with the Lisa and Macintosh Portable did not halt Apple's ascendency either. AI is not going away. The historic precedent suggests as much.

Innovation is not possible without trial and error. Failure begets success and, while this may penalize the complacent businesses, it also rewards the creative ones. The latter part of this dynamic has an overpowering effect. Strategically disciplined investors know the ever-constant presence of innovation helps limit worst-case scenarios for the broader equity markets over the long term. Consider that since 1928, the worst calendar year for U.S. stocks was -43%, while the worst 30-year annualized return was +8%[v].

Said differently, the markets become less risky over prolonged periods of time. Our patient capital mindset anchors to this notion.

Technological advancement conjures up futuristic images but is broader based. For instance, on the list of the 2025 breakthrough technologies assembled by the MIT Technology Review are green steel and cleaner jet fuel. These may not be flashy advancements, but impactful. They are also demonstrative of the ever-present drive to find better and cheaper ways to do things. Callan Family Office is similarly driven to enhance our platform and client experience. Last year, we completed our strategic investment in Aris, a trading platform ushering in cost and tax efficiencies for our clients' direct benefit. And that was not all.



In 2024, Callan Family Office added a business and transaction advisory team with experience navigating tax nuances within the entrepreneur's ecosystem. They have sharpened our focus on U.S. Code § 1202, which applies to qualified small business stock (QSBS). There are various requirements and meeting them shields federal capital gains up to the greater of $10 million or 10 times the adjusted basis of the stock[vi].

This tax benefit also intersects with our desire to invest in early-stage companies building the technologies of tomorrow. Our platform venture capital funds, a recurring allocation for us, can acquire these U.S. Code § 1202 eligible businesses with potential flow-through tax benefits to fund investors. Do not take this as tax advice (check with your CPA or tax counsel before investing). Rather, it should highlight our creative ethos and keen focus on finding investments with both attractive pre-tax returns and after-tax outcomes.

Inflation Trends

The tip of the DeepSeek saga has been the bout of equity market volatility it created. There are other significant, more far-reaching economic effects as well. Consider what Nvidia's CEO, Jensen Huang, said in late February:

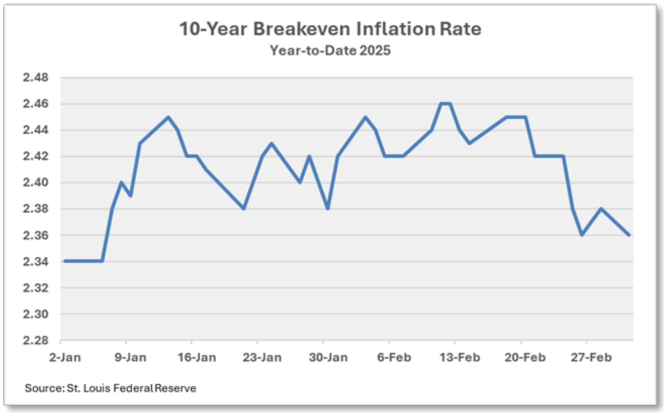
> "It's making everybody take notice that, okay, there are opportunities to have the models be far more efficient than what we thought was possible… And so it's expanding, and it's accelerating the adoption of AI."

Our take is that "more efficient" means cheaper, and so we see again the effects of technological advancement on inflation. It is on display when a Google search replaces the cost of an encyclopedia or when mapping the human genome falls from $1 million to less than $1,000. More broad evidence comes with the century-long downward trend in real commodity prices, which partly comes from finding more creative ways to generate supply, such as horizontal drilling techniques for gas[vii]. The disinflationary effects of innovation have been evident for generations. Now DeepSeek could do the same with AI.

The bond market seems to agree. The bellwether 10-Year U.S. Treasury started the year yielding 4.6% and now stands at 4.3%, which means the credit markets are pricing in lower inflation over the next decade. Breakeven inflation rates (10-Year) at 2.34% on March 7th, the lowest they have been all year, further corroborate this. There is disagreement with this perspective considering how the equity markets have acted this quarter. The market volatility tied to the tariffs levied on Canada, Mexico, China, and the United States enacted this year are suggestive of more entrenched inflation.

This manifested in an abrupt sell-off of more than 5% in the S&P 500, with Small Cap stocks and the tech-heavy NASDAQ faring even worse. While we remain focused on the long-term disinflationary impulse of innovation, along with what the bond market insinuated, equity markets saw the short-term issues with tariffs to be longer lasting. A disconnect has taken hold, and one our smoke-detector minds need to analyze.

Analog Concepts



Seeing the unnerving equity market sell-offs as a false alarm is never easy, which is no different in our digital age. Analog tactics can help. Namely, we lean on Modern Portfolio Theory, which is hardly 'modern,' as economist Harry Markowitz introduced it in a 1952 paper. At its core, it espouses thoughtful diversification within a portfolio. This remains a key risk management pillar of ours, and one that showed its worth in the recent quarter. Bond prices, which move inversely to their yields, highlighted this being up more than 2% year-to-date[viii]. Besides being a valuable ballast, fixed income can be a potential source of funds for opportunities that invariably present themselves in times of market turbulence. Not having all your eggs in one basket remains a tactic with a timeless quality.

Since the March 2009 lows, the S&P 500 has had 30 pullbacks of 5% or more and for several reasons, including previous tariffs and inflationary issues[ix]. They were false alarms and opportunities for patient capital. This historic precedent is important. Earnings, the lifeblood of stock returns, are also critical, and companies are generating this in robust fashion. Notably, S&P 500 companies just reported the highest earnings growth (+17.8%) since the fourth quarter of 2021[x]. When we look beyond the bulk of what is transpiring within financial markets, we see a digital age unlocking a wave of innovation and productivity gains. Earnings are proof.

In Parting

On Sunday, March 2nd, an American private company, Firefly Aerospace, executed the first fully successful moon landing by a commercially built and operated robotic spacecraft. This remarkable technological achievement fell outside the mainstream news cycle. It highlights key points. First, innovating remains a constant, irrespective of AI, tariff, or inflation concerns. Second, many companies at the forefront of technological advancement are private companies, which is why we believe private equity should be a strategic portfolio allocation. Last, it is a reminder of the iceberg principle that can cloud and disorient our view of financial markets. It is why we need to be careful not to catastrophize. Anchoring to key market drivers helps avoid doing so, including a focus on our digital age and its meaning for earnings, inflation, and more. We want a complete, balanced perspective of the market and economic landscape.

The current quarter has been a reminder that taking calculated risks within the financial markets can have outcomes that are neither comfortable nor follow a straight-line path. We embed into our decisions a perspective that embraces this reality and draws on our decades of experience in both robust and difficult markets. Please reach out to your relationship team to find out how these discussed themes and ideas are incorporated into your individualized portfolios.

Your relationship is valuable to us, and we thank you for it. If you would like a copy of Scott Galloway's The Algebra of Wealth, please let your Relationship or Investment Manager know and we will send you a copy.

For more information visit us at:
www.callanfo.com

[i] AI’s Economic Potential Could Reach $25.6 Trillion, McKinsey Predicts (June 25th, 2023)
[ii] Tech megacaps plan to spend more than $300 billion in 2025 as AI race intensifies, CNBC (February 8th, 2025)
[iii] Harvard Business Review, What to Do When Your Mind (Always) Dwells on the Worst-Case Scenario (September 5th, 2020)
[iv] https://brie.berkeley.edu/sites/default/files/149ch6.pdf
[v] @CharlieBilello
[vi] U.S. Code. "26 USC §1202."
[vii] International Monetary Fund, The Long-Run Behavior of Commodity Prices: Small Trends and Big Variability (July 2002)
[viii] iShares Core US Aggregate Bond ETF return as of March 4th, 2025
[ix] @CharlieBilello
[x] FactSet, Earnings Insight Infographic: Q4 2024 By the Numbers (February 27th, 2025)

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