TLF

Brompton Tech Leaders Income ETF

Portfolio Manager Commentary - December 31, 2024

U.S. Market Review

Global equity markets finished the year with another year of strong performance bolstered by a combination of moderating inflationary pressures, easing monetary policy, and resilient corporate earnings. Enthusiasm over the artificial intelligence (AI) theme drove significant gains in U.S. indices. Donald Trump's victory in the U.S. election also helped boost the domestic equity markets on the expectations of deregulation and a corporate tax cut despite uncertainties surrounding his proposed tariff and immigration policies. In global equity markets the MSCI World Total Return Index finished the full year with a 19.2% gain, while the S&P 500 rose 25.0%, climbing to all-time high in November. Communication Services (+40.2%) and Technology (+36.6%) were the best-performing sectors. Both sectors benefited from the development of AI themes. The S&P/TSX Composite Total Return Index was up 21.7% buoyed by Technology and Financials. In Europe, the STOXX 600 Total Return Index registered a 9.6% return for 2024. Spain, Italy, and Germany were the best-performing countries, gaining 20.0%, 18.9%, and 18.8%, respectively, while the U.K., Switzerland, and France all finished in positive territory, up 9.6%, 7.5%, and 0.9%, respectively.

Inflation continues to moderate, which has enabled global central banks to shift to accommodative monetary policies. In the U.S., inflation was 2.9% in 2024, while the unemployment rate remained relatively low at 4.1% as of the end of the year. The U.S. economy remains healthy and has managed to avoid a recession. However, the manufacturing PMI remained below 50 in the second half of 2024, which is an indicator of softness in the manufacturing sector. As the inflationary pressure meaningfully abated, the Federal Reserve started its long-awaited cutting cycle in September. The bond market was volatile in Q4 with the U.S. 10-year Treasury yield rising sharply from 3.6% in September (the lowest of the year) to approximately 4.6% by year end, which resulted in a steepening of the yield curve. The rebound in yields raised concerns over inflation returning due to President Trump's tariff and immigration policies, which has resulted in fewer rate cuts being priced into the market for 2025. Global bond markets, such as the U.K. Gilt and the German Bund, mirrored the sell off in U.S. Treasuries. In equities, growth outperformed value for both large cap and small cap, while large cap tech names were the primary contributors to the index performance even though they showed signs of losing momentum during the back half of the year. Strong performance was also seen from a broader group of stocks in 2024 relative to 2023, including strength Financials and Consumer Discretionary.

After kicking off the interest rate cutting cycle with a 50 bps cut in September, the Federal Reserve (Fed) cut interest rates by 25 bps each in the November and December meetings bringing the target range to 4.25%-4.5%. However, at the December meeting the Fed triggered a market sell-off after Fed Chair Jerome Powell emphasized a more cautious stance on the number of interest rate cuts expected in 2025. By the end of December, the Fed Funds Futures have priced in two additional 25 bps rate cuts in 2025, which was down from four cuts priced in as of September. Despite inflation coming down significantly, it remains slightly elevated relative to the Fed's 2% target. Therefore, we expect the Fed to tread lightly with interest rate cuts in 2025. On the political front, Donald Trump won the presidential election, and Republicans took control of Congress. The new administration's policies surrounding tariffs, immigration, regulation, and taxes will be the key to watch heading into 2025.

Artificial intelligence remained the year's dominant investment theme fueling market enthusiasm and a transformative industry shift. The "Magnificent Seven" mega cap tech stocks delivered outsized returns, boosting the S&P 500 Total Return Index. The seven names added about $6 trillion of market cap in 2024. Meanwhile, broader market breadth, indicated by the advance/decline line for the S&P 500, suggests wider participation in the rally beyond large-cap tech. Consecutive Fed rate cuts, durability of the U.S. consumer, and optimism around pro-business policies from the Trump administration bolstered equity performance in sectors such as Financials. According to the latest World Economic Outlook update issued by the International Monetary Fund in October 2024, the global economy is projected to grow 3.3% in 2025, revised up by 0.1 percentage points from the July forecast. The outlook also highlights that persistent services inflation is impeding overall disinflation efforts, complicating the path to monetary policy normalization.

Looking forward to 2025, in our view, we expect to continue to see a widening of breadth in the market. Returns over the past 3 years have been dominated by the "Magnificent Seven" mega cap stocks. This trend peaked in mid-2024, and we have recently seen outperformance from a broader group of stocks, including mid-caps, particularly on the back of the U.S. election results in November. While we are still bullish on the Technology sector, broadening participation is positive for stock pickers and active management. In terms of the economy, we believe that a soft landing has been achieved and that we remain on a path back to normal in terms of both inflation and interest rates. The U.S. economy will continue to benefit from a strong consumer and continued growth in private sector capex, particularly around the themes of re-shoring, electrification, and artificial intelligence. The incoming policies under the new Trump administration will be the key to drive the market sentiment. Tax reform and deregulation would stimulate growth and benefit in particular domestic and cyclical sectors, while tariffs and trade policy uncertainties could create headline risks. We also expect increased volatility in 2025 and believe that investors will be well-served by strategies that have historically demonstrated lower volatility than the market, such as dividend growth and covered call strategies.

Technology Sector Review & Outlook

Technology stocks dominated performance in 2024, with the S&P Information Technology Total Return Index up 36.6% vs the broader market up 25%. Performance was concentrated in the 'Magnificent 7' stocks which were up 67.3%. Technology stocks exposed to the Artificial Intelligence theme continued to gain momentum. In addition, second derivative AI plays such as datacenters and their respective equipment suppliers have begun to experience tailwinds given an increased capex spending by large hyperscalers, with the top four projected to spend $257 billion in 2025, up 23% according to Bloomberg.

While the AI-theme does exhibit some irrational exuberance some investors have enquired when does the bubble pop. The simple answer is "we do not know", given the psychology of bubble economics. The obvious catalyst would be recessionary forces which would ignite a slow down in tech spending particularly in discretionary line items which AI falls under in many IT budgets. From a valuation perspective, tech multiples are far from frothy levels experienced during the dot com era trading at 28.5x forward Price-to-Earnings vs 55.2x. Today, large cap technology companies have significant earnings power given their scale, recurring revenue model and operational leverage. As a result, companies can grow into their valuation over time versus falling short on earnings generation at frothy multiples, the latter is consistent with prior bubbles. As an example, AI bellwether Nivida was trading at 68.3x PE in November 2021. As of January 16, 2025, it is trading at 30.7x, bellow its 5 year average of 41x with the stock up 340% during that time period.

Global IT spending is expected to reach $5.74 trillion in 2025, up 9.3 % Y/Y according to Gartner. Data center systems and software segments will both see double-digit growth in 2024, 24% and 12.6% respectively, largely driven by cloud spending. Growth is being driven by datacenters, up 34.7% to $318 billion given strong demand for generative AI. Spending on software is expected to increase 14% to $1.23 trillion and IT services is expected to grow 9.4% to $1.73 trillion.

The Global semiconductor market is projected to grow 15% to $727 billion according to IDC. Growth is driven by the memory segment, up 24%, given increasing penetration of high-end products such as high bandwidth memory because of increasing demands for AI applications. The non-memory segment is expected to grow 13%, mainly due to the strong demand for advanced nodes for AI servers and high-end mobile phones. Industry commentary suggests that US president Donald Trump could bring tighter semiconductor sanctions on China focusing on specific chip types and end-market applications such as high-grade communication and AI compute chips. Sanctions risks will likely be correlated more to the chips' applications and its nodes, rather than a company's overall revenue exposure to China. While US chip makers would be disproportionately affected, partially offsetting this would be streamlined US chip manufacturing and eased data-center regulations that will likely boost domestic growth.

We are entering another inning in the AI revolution given the pace of technological advancements, development of AI applications and machine learning algorithms. Today AI systems are becoming more sophisticated and one step closer to competing with human intelligence. Generative AI is poised to be a $1.3 trillion market by 2032 as it boosts sales for the tech industry's hardware, software, services, ads and gaming segments at a compound annual rate of roughly 43%, according to Bloomberg. Mega tech companies have a significant number of AI patents, offer machine learning-as-a-service, and can leverage their large userbase in driving AI adoption. Large enterprise software companies have begun to offer intelligent decision-making capabilities in their software as well as intelligent automation. Leading chip manufacturers and related semiconductor companies provide the silicon building blocks that make AI possible.

Looking beyond traditional tech firms, power producers, utilities, natural gas producers, and industrial companies are poised to benefit from the AI revolution. AI is an extremely power intensive operation. One ChatGPT query takes almost 10x the amount of energy of a typical google search and almost as much as keeping a 5 watt LED bulb on for an hour, while loading an AI image can take as much power as charging a smartphone. Availability of power is currently one of the key bottlenecks in data center growth. Estimates suggest that data centers could reach 7.5% of total US power consumption by 2030 vs 2.5% in 2022. One of the reasons we need so much power for these data centers is because servers generate a lot of hot air which needs to be cooled. The next gen AI chips require advanced cooling technology that traditional HVAC (air cooling) cannot handle. Liquid cooling is a far more efficient way to cool datacenters in excess of 30kW. Currently the liquid cooling market is small but is seeing 25%+ compound annual growth rate, which is higher than the data center infrastructure market itself.

We continue to believe the technology sector remains a structural growth story. Over the long-term the digital transformation opportunity, which is underpinned by enabling technologies such as cloud, hyper connectivity (e.g. 5G), digital media, e-commerce, payments and intelligent automation, provides many avenues for growth. Disruptive emerging technologies, such as artificial intelligence and quantum computing, are expected to reshape business models and drive economic value add in the global economy. Stocks in our portfolio are uniquely positioned to benefit from this growth given their respective market position in the products and services they offer as well as degree of innovation that enhances competitive moats.

Portfolio Review

In 2024, Brompton Tech Leaders Income ETF was up 21.4% ahead of the S&P 500 Equal Weighted Information Technology Total Return Index up 15.7%.

The Fund's overweight exposure to software and services contributed to performance which lagged benchmark holdings. Top performing holdings were Oracle (up 60%), ServiceNow (up 50%) and SAP (up 37%).

The Fund was underweight semiconductors, with performance well ahead of benchmark holdings. Top performing holdings include Nvidia (up 171%) Broadcom (up 110%) and Micron (up 14%).

The Fund was underweight hardware and equipment with performance ahead of the benchmark. Apple was our only top performer (up 31%).

An underweight exposure to IT services contributed to performance which was ahead of benchmark holdings. Top performing holdings include Gartner (up 7.4%) and IBM (up 7.3%).

The Fund's overweight exposure to non-benchmark sectors (consumer discretionary and media & entertainment) contributed to performance which was ahead of benchmark holdings. Top performing holdings include Meta (up 66%), Amazon (up 44%) and Alphabet up (32%).

Annual Compound Returns[1]	1-YR	3-YR	5-YR	10-YR	Since Inception[2]	Since Inception[3]
Brompton Tech Leaders Income ETF (CAD Hedged)	21.4%	8.4%	18.1%	15.3%	14.2%	-
Brompton Tech Leaders Income ETF (USD)	22.7%	9.7%	19.5%	-	-	20.5
S&P 500 Equal Weight Information Technology Total Return Index	15.7%	6.0%	14.9%	16.8%	16.2%	16.8%
S&P/TSX Composite Total Return Index	21.6%	8.6%	11.1%	8.7%	7.7%	11.5%

(1) Returns are for the periods ended December 31, 2024 and are unaudited. The table shows the Fund's compound return for each period indicated. compared with the S&P 500 Equal Weight Information Technology Total Return Index ("Technology Index") and the S&P/TSX Composite Total Return Index (together the "Indices"). The Technology Index, a sub-index of the S&P 500 Index, tracks the performance of major North American information technology companies on an approximately equal-weight basis. The Composite Index tracks the performance, on a market-weight basis and a total return basis, of a broad index of large-capitalization issuers listed on the Toronto Stock Exchange. The Fund is actively managed; therefore, its performance is not expected to mirror that of the Indices. Furthermore, the Indices' performance is calculated without the deduction of management fees, fund expenses and trading commissions, whereas the performance of the Fund is calculated after deducting such fees and expenses. The performance information shown is based on net asset value per CAD and USD unit and assumes that cash distributions made by the Fund during the periods shown were reinvested at net asset value per CAD or USD unit in additional units of the Fund. Past performance does not necessarily indicate how the Fund will perform in the future.

(2) Inception Date May 20, 2011.

(3) Inception Date August 8, 2019.

BROMPTON FUNDS

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