



The Essence

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免费的东西 (miǎnfèi de dōngxi)

One of our Portfolio Managers has a beloved brother and family. The PM tries to spend quality time with them on every occasion. Birthdays are a good time to hang out and celebrate. Recently, on the brother's birthday, the family was all together, early one Saturday.

"What shall we do today, to make it special?" asked our PM.

The brother replied ... *"Of course, we need to begin by going to IHOP for breakfast. You get free pancakes on your birthday!"*

"Um, pancakes, OK for a start. Then what?"

"You can then come with me to that car dealer I told you of, the one that gives away free pens for each test drive."

"Oh, you're buying a new car? Great day for that!"

"No, our car is fine; I just want the free pen, and you can get one, too. On our way back we must stop at Starbucks before 11:00 am for a short latte, also given away with proof of birthday."

*"So, basically, we're going to spend the day going around for FREE stuff? And you know that, for some of these things, it may cost **more** to obtain the items, than they are actually worth? The 'free pen' car dealership is 15 miles away, costing more in gas and wear & tear on the car, than the cheap pens they are offering?"*

"Well," said the brother *"You asked me what I wanted to do on my birthday and this is what I like to do best. As long as you, my daughters and my wife, Mei Lin, agree to accompany me (which you rarely do otherwise). You know how passionate I am about miǎnfèi de dōngxi!"* [Pronounced "Mee-an-fay-da-dunk-see" and meaning "FREE stuff" in Mandarin.] His daughters then chimed in reminding us about the time their father was gone, inexplicably, for several hours, one Saturday. He had done this before, so nobody was too worried. Mid-afternoon he showed up absolutely beaming, with a large bag in tow.

"What's that? What's that!" screamed the daughters excitedly, jumping up and down. *"It's for mommy; go get her."* With great skepticism, Mei Lin came into the room, took the bag and emptied its contents on the table. *"It's gray hair dye; where did you get it!?"*

"I was at the drugstore where they were giving away FREE hair dye; one box for each survey you filled out. I was there all afternoon and handed in 100 surveys. They were very mean and only gave me 25 boxes of this gray hair dye but isn't it great!?"

"What am I going to do with it?" exclaimed his wife. *"I don't want to dye my hair gray. It will turn that way naturally ... eventually."*

"But it's miǎnfèi de dōngxi!?" retorted the brother. The daughters skipped away laughing while the wife walked away in disgust. *"What am I ever going to do with you?"*

Our PM was recently reminiscing with the family as these stories were recounted. Our PM wound up on the floor, in stitches with laughter. It was so funny because his brother hardly needed those FREE items. There are many people in this world who

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literally could not survive without some help, in various forms (though not necessarily gray hair dye); thankfully he is not in that group, and this is a very different topic for a very different discussion. It seemed like it was a game or treasure hunt, more than anything else. “*But you know what, brother,*” said the PM, “*it seems like you are not alone in loving FREE stuff, useful or not.*”

This simple birthday “celebration” got us thinking about the topic of FREE stuff, and its investment ramifications. Perhaps the brother is extreme, but there is a certain fascination that people have with FREE stuff. What does it all mean?

Is it really FREE?

Miǎnfèi de dòngxi is a common expression in many languages. It seems that many folks (and businesses) like FREE stuff. Why wouldn’t you? Companies may offer FREE stuff to build valuable business models:

- McDonald’s (and other food outlets) often promote FREE (or perhaps merely discounted) stuff. “*Here’s your \$1.99 burger; want fries and a drink with that?*” They know that the higher margin add-ons will more than make up for the discounted burger.
- Starbucks “gives away” FREE WiFi to keep you in their stores for that second latte down the road. Generally, the WiFi model is an interesting one in that by clicking on that FREE password, one agrees to allow the store to track (and sell) your browsing history. FREE indeed!
- Often the business model includes something for FREE today, so as to “hook” you for future sales. College-aged consumers are known, as a group, to have higher delinquency rates on credit cards than more established borrowers. But Wells Fargo charges them no more on borrowings than their parents, with the long-established knowledge that college borrowers often turn into lifetime (profitable) customers.
- Gillette literally invented the “razor/razor blade” model selling razors near cost so as to keep the users buying blades literally forever. And there are plenty of other examples.

We at Aristotle Capital study these business models so as to uncover what’s likely to work long term. While continually used, some models seem to rarely work:

- Discounted staple items in supermarkets is a model we scratch our heads over. These store sales – “buy one/get one free” and other promotions – often merely serve as time-shifting strategies. There’s only so many bags of chips a family can eat, so putting them on sale today merely means they will not be purchased tomorrow. We find this *could* work for new brands, as offering FREE samples could result in brand-building loyalty. But for existing brands (which we see much more often), we question its value.

➤ “Freemium” models, while providing some value to businesses, often are not worth the effort. Many of us will soon be downloading tax preparation software, perhaps from Intuit’s *TurboTax*, or a competitor. The idea is to offer the service for FREE upfront, then offer a more premium version as the preparation process progresses. For instance, one may use federal tax prep. software for FREE (or at a very low cost), only to be required to pay more for the oft-required state packages. Our PM’s brother would surely be annoyed at this tactic, perhaps deemed as “bait and switch.” Goodwill from this model is hard to come by.

➤ Companies, particularly nascent startups, give away FREE stock or stock options to attract the “best and brightest” to their firms. There are reports of multimillion-dollar packages offered to recent college grads to lure them with their “worldly A.I. ‘expertise.’” Public companies do this too, then exclude these “non-cash” charges from what they call “adjusted” earnings. But these costs are real, essentially diluting existing shareholders’ ownership. While the newly minted employees enjoy these benefits, the business model itself may not be sustainable. At the least, we favor companies that clearly disclose these benefits as a true expense in their reports.

➤ What about the current rage of weight-loss drugs? “*Pop a pill and then eat what you want!*” According to published studies, 65% of those who take peptides (GLP-1s) for weight loss quit within the first year. Is it really a FREE way to lose weight and **keep it off**?

Much of our work, over the decades, has shown that when something is FREE, it is often not very highly valued. It does seem that FREE is a temporary, but often not permanently sustainable, business model. Those FREE pens at the car dealership would never result in an auto sale ... at least not to the PM’s brother.

Opposite to FREE is a business model that appears to us as more sustainable over time. Thus, instead of selling a “cheap” or less-valued product or service at a low (or FREE) price, successful companies develop **premium** products or services and sell them for premium prices. Take, for example, Corteva, an agricultural services company spun off from Dow Chemical in 2019. It has two primary divisions that are in the process of being split into two separate companies. Crop protection is considered by some to be more “commodity” like and subject to price competition and generic substitutes. The seeds business is much more unique, selling corn, soybean, wheat and other seeds to farmers who then plant and grow the crops. Examine the picture on the next page:

Here we see, on the right, corn stalks from traditional seeds succumbing to “rust,” a type of fungus. On the left are stalks grown using Corteva’s multi-disease resistant seeds. The company may charge a premium for its products as the resultant revenue to farmers for healthy crops is significant.

Premium Pricing



Source: Corteva 3Q25 Earnings Report

what truly differentiates companies from one another, other than pure price.

There is no “one size fits all” business model with regards to FREE, or most anything else. For some customers, this model can work as it offers a trial to the company’s product or service. Perhaps married with a premium experience, this model can be quite successful. We shall continue to differentiate between businesses, with our goal being to understand

the Index’s sales and earnings, implying historically elevated valuations after very strong stock price performance.

It is highly unusual (perhaps even unprecedented) to have a market “bubble” be called and end. We do not pretend to have this expertise and will not telegraph our interest in acquiring such. We do know that there is no magic “bell” that rings to alert us of financial markets transitions. But we are mindful that they do occur and typically when few are forecasting it. A reasonable, but not absolute, conservative strategy has typically fallen behind the median of others during the type of “momentum” driven market we are in. Chasing what is “working” in the short term, to remind our readers, is not what we wish you to expect of us.

Artificial Intelligence (A.I.) investments have contributed meaningfully to the concentrated nature of the equity markets as detailed above. Aristotle Capital has some, but not excessive, exposure to these trends. Whether or not we are in such a bubble is still to be seen. What we believe may happen is what almost always **has** to come to pass over time. That is, the benefits of new technologies (such as A.I.) will increasingly accrue to its most adept users. We are too early in its ascent to know who these winners will be. We will continue to study these adept users, as the value chain of A.I., over time, switches from its “builders” to its “users.” Clearly, we will have more to say on this topic in future editions of *The Essence*.

As for other drivers of the U.S. economy, there is an old adage: “*When the U.S. consumer feels good, s/he shops; when the U.S. consumer feels bad, s/he shops more!*” Thus,

even in the face of divisive politics, fighting around the globe, excess debt the world over and other factors, U.S. personal consumption expenditures rose an estimated 2% (final figures not yet available) in 2025. This was driven, consistent with prior years, mostly by services such as housing, healthcare, financial services and “other.” (How many haircuts did you have last year?)

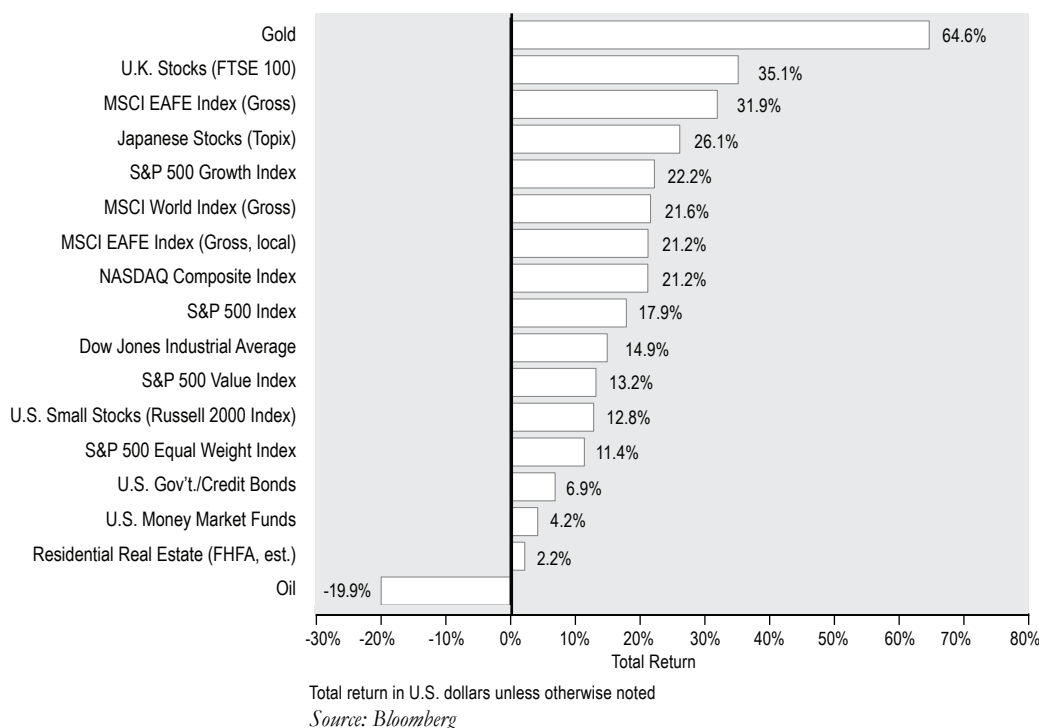
While overall the U.S. consumer continues to spend, one area that remains mired in the doldrums is housing. This, too, is consistent throughout most of the developed world. We have remained in an unprecedented environment whereby the value of the U.S. housing stock is at

EQUITIES STRATEGY

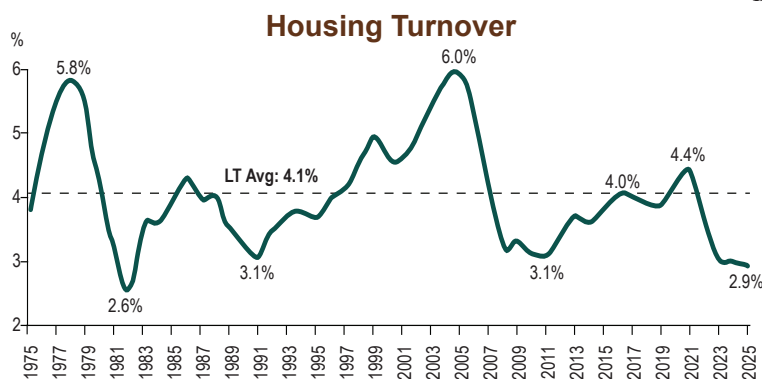
For most years for more than a decade, asset returns were similar to those we present here for calendar 2025.

Note the strong double-digit returns of most equity asset classes. Note, too, the disparity between the S&P 500 Index (+17.9%, including income) and its Equal Weight counterpart (+11.4%, including income). Indeed, seven of the 500 companies in the Index now represent greater than 31% of its market capitalization. These seven firms, while profitable and growing, represent far less than 31% of

2025 Asset Performance



record levels. The Federal Reserve (Fed) estimates the value of all U.S. residential housing is at a record high ~\$50 trillion. Subtract an estimated ~\$14 trillion in mortgage debt and that leaves ~\$36 trillion in home equity value. This is up from an equity value of ~\$22 trillion ten years ago. It is highly unusual that this ~\$36 trillion is not being put back into housing (or at least home improvement). The reason given is that the turnover of our housing stock is near record all-time lows.



Source: Home Depot Analyst Day Slides, December 2025

Note that at 2.9%, the annual rate of existing home sales in the U.S., as a percent of the total stock, is (other than during the 1981 depth of a recession point) the lowest in fifty years. This, together with a relatively low 1.4 million new housing starts, and the message is that households are staying put. Contributing to this phenomenon is a high employment rate (people don't need to move for a new job), high prices and, relative to the recent past, high mortgage rates. This combination makes it costly to move. So, without a major reason, households stay put. While housing, by itself, is only about 4% of GDP, add in residential investment (such as construction or remodeling) and housing services (including utilities and imputed rent), and the total is ~16% of GDP. There are also well-documented add-on effects of brisk housing turnover, which is not occurring. This sector is in a near depression. While there is good reason to believe it will rebound, thus far that improvement is elusive.

Elsewhere around the world, at 50,339.48, Japan's Nikkei 225 stock index closed at an all-time high; only the second time since its bubble era of 1989. While, like elsewhere, A.I.-related companies helped lead the charge, Japan is also benefiting from corporate governance reform and a partial global return to its manufacturing heritage.

While the populations, economies and earnings of emerging market countries have generally outpaced those of developed countries over time, this is not yet reflected in the relative value of the companies in emerging markets. Volatile politics (and the market uncertainty that accompanies it) has kept such developing country companies from realizing their full potential. China remains the largest influence and biggest swing factor. Thus, while the South Korean KOSPI Index gained 82.7%

(as measured in U.S. dollars, including income) last year and Poland, Vietnam, Chile and Mexico also rose sharply, still, emerging market public equity values represent only ~11% of world markets. Europe is now below 15% (from over 30% at the beginning of this century) while the United States is close to *two-thirds* of the world's equity market capitalization. [All figures as reported by Yardeni Research, taken from MSCI indices.] We will have more to say on this, and related topics, in future editions of *The Essence*.

INVESTMENT ACTIVITY

We would now like to highlight a recent addition to Aristotle Capital equity portfolios.

- **Fast Retailing** sells inexpensive "basic" clothing (tees, shorts, socks, underwear and the like), but not for FREE. Based in Japan, its largest store brand, *Uniqlo*, was named due to a clerical error on paperwork in the 1980s, as shorthand for Unique Clothing Warehouse (UNICLO). Founder Tadashi Yanai liked the misprint and kept it. Other brands are *GU* (pronounced "Gee-You"), a simpler slightly lower-priced version of *Uniqlo* and *Theory*, a traditional American clothing brand purchased in full in 2009.

We can think of only a very few retailers whose concept has transferred well outside their home country borders. McDonald's, Starbucks, Pizza Hut, Costco (but not its competitor Carrefour), IKEA, 7-Eleven, Zara and H&M are some of the largest successes. Many others, while continuing to thrive in their home markets, fail when going internationally. That, too, was the case for Fast Retailing as *Uniqlo* could not gain meaningful traction in the U.S., Europe or even nearby China. That has recently changed and is a major *catalyst* for our recent investment. Its success in Japan continues, but it has largely saturated that market. If Fast Retailing's normalized market share in the U.S. and Europe matches that of Japan (or even if it's somewhat lower), the resultant value to the company and stakeholders could be meaningful.

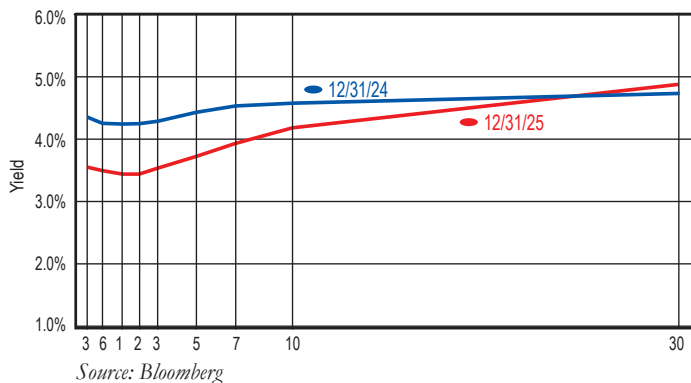
While Yanai-san (at age 76, still the company CEO) is not quite as interested in *miǎnfēi de dōngxi* as our PM's brother, he is quite thrifty. "*Do I get the employee discount?*" he asked while shopping in Tokyo. He was immediately recognized by the store clerk who asked for his employee ID number. "*One,*" replied Yanai. "*OK, sir, that will do; thank you for your business!*"

STANDARDS OF LIVING / INTEREST RATES COMMENT

Perhaps unintended, and certainly with consequences, we may definitively say that the cycle of ever-lower (even negative) interest rates throughout much of the world has

been broken. We have long believed that interest rates (typically correlated with inflation) within a band, say 1%-4% in the developed world, are “acceptable,” resulting in rational sustainable economic results. Above or below those bands, and a hard-to-correct spiral becomes possible or even, in certain circumstances, hard to avoid.

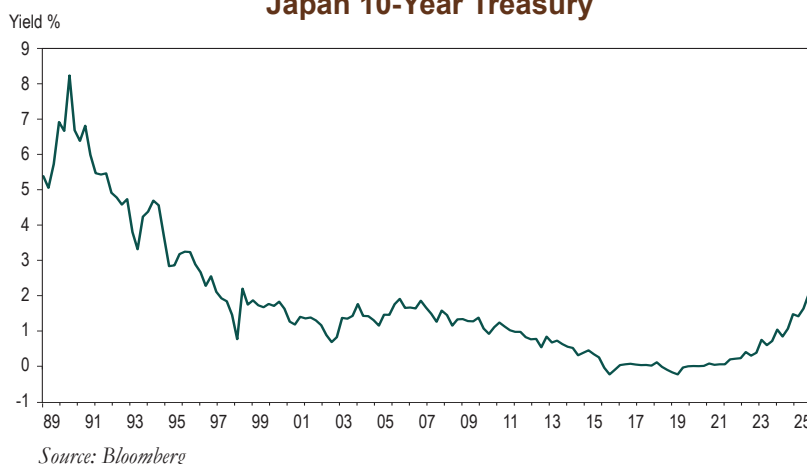
**U.S. Treasury Yield Curve
12/31/24 versus 12/31/25**



As the graph above shows, the Fed lowered short-term interest rates again during 2025. The federal funds target rate now stands at 3.50%-3.75%, 75 basis points below where it began the year and fully 175 basis points below its peak, established in late 2023. Longer-term rates declined too last year, but not by the same magnitude as short-term rates. The very longest-term 30-year Treasury bond yields actually *rose* ever so slightly last year. There remains some concern about the rate of inflation, thus it may take a sustained leveling out of overall prices for longer-term interest rates to decline meaningfully. This is relevant for mortgage rates, which are typically tied to 10-year Treasury yields. [Note that we will have a new Fed chairperson, to be announced very soon, effective in May of 2026.]

Going the opposite way, Japanese government bond yields rose substantially last year.

Japan 10-Year Treasury



Note from this chart that Japan’s 10-year government bond yield closed the year at just over 2.0%, the highest in more than *twenty-five* years. We are always mindful about unexpected consequences when a long-term trend reverses. Japanese financial institutions own long-term bonds; real estate developers assumed that capitalization rates (net operating income as a percent of property value) would remain sub-4% indefinitely (and have been able to borrow development funds accordingly); insurance and other firms invested overseas seeking higher yields (with commensurate currency risks); individuals were content to keep vast deposits in Japanese banks, themselves seeking higher yielding assets to grow earnings, etc. While it has been long telegraphed that Japan’s interest rates would eventually have to rise, we remain vigilant in understanding the resultant changes from these actions.

One of the consequences we seek to understand is the role that Private Credit had/has within the Japanese financial system. A term we’ve heard more of late, but what is Private Credit? While our partners at Aristotle Pacific Capital have greater expertise than do the authors herein, we believe it is relevant for the overall economy, interest rates and financial markets to understand, in general, this potentially disruptive industry. Not just in Japan.

Following financial regulations that tightened bank lending after the global financial crisis, Private Credit (non-bank lenders) stepped in to fill a funding void, becoming a significant source of capital for businesses outside of (at the time, increasingly closed) traditional banking channels. Fast forward to today, even with banks seeking to lend more, even with some of the regulations loosening and even with credit spreads relatively narrow, Private Credit continues to take a meaningful share of lending business from traditional banks. Why?

Because these lenders offer customized, often faster, often more flexible terms (such as all-important covenants) on loans for growth or specific needs, appealing to investors with potentially higher yields and to borrowers seeking tailored solutions. How?

To fund loans, most banks accept deposits from businesses and consumers. These deposits are largely “on demand” meaning they may be redeemed at a moment’s notice. Step in government regulators; trying to avoid extreme negative consequences of “runs” on banks, they insist banks keep a certain amount of capital in reserve (either on deposit at the Federal Reserve or elsewhere) so as to be able to meet all but the most severe demand for a return of those deposits.

Private Credit lenders are not banks, are not subject to these capital rules and do not fund their loans with personal deposits. Instead, they attract longer-

term funding from insurance companies, retirement funds and other institutions that agree not to “demand” this capital back for a specified period of time. Japanese financial companies have been a meaningful source of funding, seeking higher returns than the near-zero they were able to earn at home. It all sounds wonderful, right?

Well, there’s the promise and then there’s the reality. In “good” times (including today), all is well. In “tougher” times, when some of these private loans go unpaid, how would these “more sophisticated” institutions actually behave? What if they, too, at the same time, have a need for their capital back? Surely, as most always is during times of volatility, some of these institutions will find themselves in that predicament. Even if capital is contractually tied up, would they not at least try to get at least some of their money back sooner? Perhaps accept a discount to what they are owed? Howard Marks of Oaktree Capital (a firm that knows quite a bit about fixed income investing) recently said, “*As we know from past financial crises, when a mass of debt gets written down, the debtholders are often forced to flog off good assets on the cheap along with the bad ones.*” If this occurs, “contagion” will rule the day and not be good for anyone.

Our point is that – consistent with our theme of FREE stuff – the rise of Private Credit may not (likely will not) be for free. We are not predicting such dislocations anytime soon, but, as always part of our thought process, we will continue to learn more about the ramifications of Private Credit, be it in Japan or elsewhere, so we may *optimize* our investments. While often a precursor of turmoil, overall credit spreads have remained within reasonable historic ranges in recent years. But our investment style is always to look out for what could be “gotchas.” In this case, we are monitoring the explosive growth of Private Credit as we know full well that, indeed, little is truly “FREE.”

We sadly acknowledge the passing last year of one of the co-founders of Aristotle, Steve Borowski. Some people are created and, from birth, spread joy to all those they touch. Literally thousands of lives were directly touched by him and multiples of that by association. Our pangs of pain, longing and missing will be forever with him and his dear family.

CONCLUSION

Unlike most of what you just read herein, there do exist examples of something for “free” being truly valuable. Take, for example, the character and story of “*Rudolf the Red-Nosed Reindeer*.” According to history as taken from Wikipedia, the Free Encyclopedia, the cute little deer (scientific name *Rangifer tarandus*), who was different from the others, was created in 1939 by Robert L. May. Rudolph first appeared in a booklet written by May, an in-house copywriter in the advertising department of Montgomery Ward. The department store – one of the largest U.S. retailers at the time – wanted to save money on the coloring books they bought and gave away to children, free at holiday time. So they asked May to create their own. As he was staring out his office window in downtown Chicago, pondering how best to craft a Christmas story about a reindeer, a thick fog from Lake Michigan blocked his view – giving him a flash of inspiration. “*Suddenly I had it!*” he recalled. “*A nose! A bright red nose that would shine through fog like a spotlight ...*” Miǎnfēi de dōngxi for the children, low cost to Montgomery Ward and a children’s tale for the ages. We all win!

“Nothing by rote” is part of every agenda for Aristotle Capital research meetings. It reminds us that every business we study has its own unique attributes, strategies, strengths and weaknesses. They must be analyzed individually, never mindlessly as part of another’s story. We describe **Free stuff** in this edition of *The Essence* as a generalization that people put greater value on “stuff” they pay for. Businesses may “rent” loyalty by lowering prices or making things free. But true enduring brand value is built via careful analysis of what customers truly want and appreciate. They then must craft such products or services, charging a reasonable price so as to optimize their long-term returns. Then we, including shareholders, all win.

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