Investment Update

THE FIRST HALF: TO INFINITY & BEYOND…

As Buzz Lightyear quipped in the Pixar Classic *Toy Story*, "to infinity and beyond." The equity markets met little resistance in their march higher during the first half of 2024. Aside from a modest pullback in April, the "broad markets" saw a nearly unrelenting push higher. Beneath the surface, however, lies a much more nuanced story we believe is likely to have repercussions in the months ahead.

In the first quarter recap we noted "***Momentum is a funny thing…it can last longer than most expect and dissolve quicker than most are prepared to handle!"*** That remains a very true statement today. At the halfway point in 2024, the 10 largest components of the S&P 500 have contributed 11.13% of the index's 15.29% return. Said another way, not owning NVDA and MSFT alone mean nearly 6% underperformance vs, the index. Concentration became more exaggerated in Q2, with two names accounting for more than half of the index return!

The market described above is anything but a "broad" market. Far from uniform, meaningful segments of the broader markets were flat to negative in the first half. Only 24% of S&P 500 stocks outpaced the broad index, the smallest percentage on record (following only 26% outpacing in CY 2023). Small cap stocks are the most glaring among the laggards, trailing the S&P 500 by the most over a 12-month span in the 40-year history of the Russell 2000.

Diversification away from large cap/mega-cap tech and AI "darlings" meant smaller first half returns. Owning blue chip, dividend stocks meant solid performance, but well below the index's +15.29%. Owning dominant international brands meant a solid mid-single-digit return for H1.

As we did a quarter ago and as we turn the page on the first half, on the pages that follow we tackle the questions we hear from our best clients every day.

- Should I move more dollars to what's working right now? Should I look more like the index itself?
- It's different this time with AI…don't you agree?
- Why should I own all these "boring" industrials and energy positions?
- Is everything overpriced? Are we not in for a huge correction?

While equities continued their banner run, the bond index (AGG) posted a lackluster -0.7% in the first 6 months. Markets continue to debate timing the Fed's first cut and whether the sign of economic slowing is good or bad news.

Heading into the second half of 2024, we reiterate that guessing in "bond land" had been a costly venture to many. We continue to believe bonds should help stabilize rather than destabilize a portfolio. We will touch on our current positioning that has once again helped our bond allocations outpace the AGG (by more than 4% on a YTD basis).

Below are questions we will tackle:

- Why shouldn't I keep "rolling" Treasuries or CDs?
- If the economy is slowing, why should I own credit-sensitive bonds?
- If the Fed's nearing its first cut, should I start to add duration?

TACKLING THE TOUGH QUESTIONS: EQUITIES

Should I move more dollars to what's working right now? Should I look more like the index itself?

Warren Buffett is credited with saying *"The stock market is a device for transferring money from the impatient to the patient."* While positioning is 100% a client-by-client exercise, the short answer to the question is NO. We believe patience will be rewarded. The index has been the beneficiary of a historic move by NVDA and very robust moves by its supporting cast of six others.

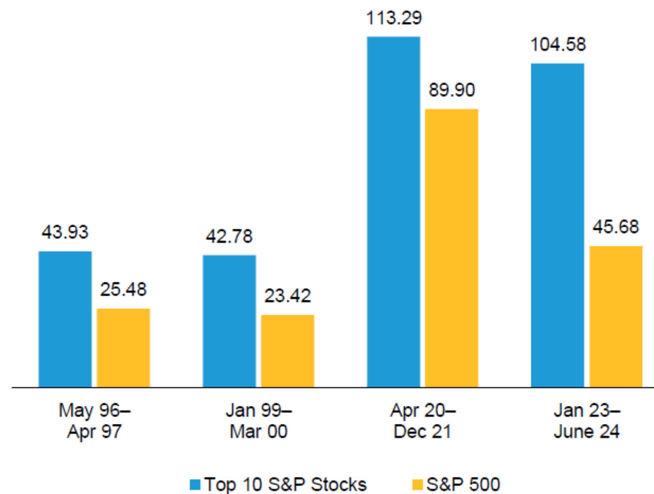
Undeniably, these are remarkable companies with huge market share who play in the most exciting segment of the market in 2024 (AI). They have been cash flow machines over the last 18 months. The Earnings per share growth of the Mag 7 was 12x that of the other 493 stocks in the S&P 500 in the first half.

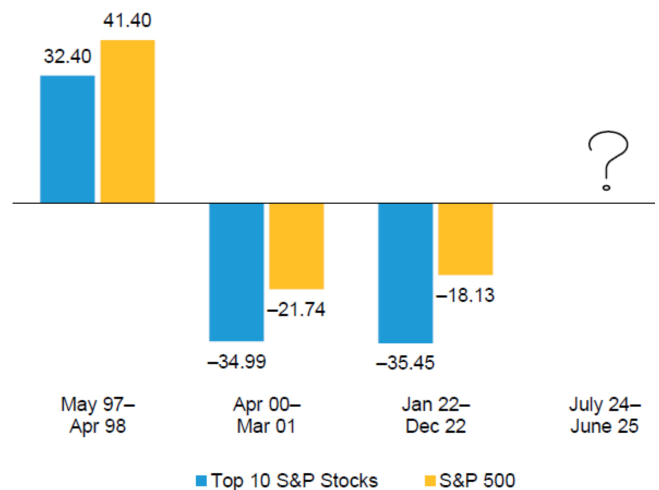
We are not predicting gloom and doom for these names, but rather a "catch up" by many of their peers in the index. Estimates for the next 4 quarters show a much closer race when comparing earnings growth. ***Why does that matter?*** Over time, stock prices tend to closely follow earnings growth. Whereas the Mag 7 trade at P/E multiples north of 30x, the rest of the index trades at roughly half that figure.

Historically, an investor's return is largely determined by the following: (1) price paid for a security (2) dividends paid out (3) holding period. We feel the price paid element is discounting the opportunity in the non-Mag 7 relative to the dominant names at the top of the index. The two charts at right lend historical support to the case for "the rest" of the names outpacing the Top 10.

We are NOT suggesting investors avoid owning NVDA, MSFT, GOOG, AAPL, or any other great brand. Rather, we believe it is judicious to pay close attention to the price paid for such leaders and recognize the possibility of value being unlocked from other segments of the markets more broadly. Cuts by global central banks (including the US Fed) historically have benefitted non-US equities and small/mid cap companies. Add the discounts of these two segments relative to US Mega cap names and a strong case can be made for a different leadership cohort in the equity markets in the coming quarters.

Again, this is NOT suggesting that the Mega cap tech names miss earnings or perform poorly, but rather that a lot of good news is priced in on these companies while much less optimism is reflected in prices elsewhere. Rather than over 35% allocated to 10 stocks, we believe a more balanced approach that emphasizes the "other 490" is prudent at this moment in time.





JP Morgan Securities (the institutional arm of the nation's largest bank) summarizes their cautious tone in the following: *"we recommend diversifying away from momentum tail risk (a.k.a. what's worked of late) by adding allocation to anti-momentum defensive value plays (i.e. utilities, staples, healthcare, telecom, Dividend Aristocrats)…"*

Of note, our positioning already reflects a conscious overweight to segments of the market like those JPM referenced. We aren't making a bet on a broad market shift, but rather conviction that there is opportunity well beyond a handful of great companies.

It's different this time with AI…don't you agree?

When speaking of innovations that changed society, the railroad system, electricity and refrigeration, air travel and the internet are among the biggest game changers in the last 200 years. Cloud storage, cell phones, and color TV fall a notch lower in our eyes. Where does AI fall in this spectrum…nice technology or game changer?

Time will tell! AI is largely the final phase in the evolution of the "big data" movement of the last 15 years. Today's AI is different in many ways, especially in the money being spent on its integration. AI has an ability to help speed up innovation, enhance productivity, and remove people from some of society's more mundane jobs. AI also consumes a tremendous amount of energy to do these things…a challenge whose solution will likely require huge infrastructure investment to meet demand.

We are not AI skeptics but believe the pace of benefits and spend are extraordinary and that the likely next step is a reevaluation of that spending in the coming years. Per Accenture many companies don't have their data structured in such a way that they are even close to unveiling AI solutions that drive/enhance profitability. AI could change our lives materially (it must, given the amount of spending), but any setbacks could meaningfully slow the spend in this space.

The ultimate winners of AI likely include some of those in the news now (NVDA, MSFT, GOOG, META) along with a long list of companies less familiar and smaller. Beneficiaries likely won't be exclusively tech companies but will include businesses across industry. JP Morgan Securities' Eduardo Lecubarri put it this way: "*Consensus says Large Caps will be the winners of AI…History says they won't.*" He further referenced the 16 year (Mar 00-Jan 17) flat performance for the S&P Technology sector that followed the late '90's rally. During this span SMid beat large caps and he suggests we should learn from that era.

American Funds' Chris Buchbinder, a 28-year industry veteran and telecom analyst in the late 1990s said it this way: *"I do expect we will reach a zone of disillusionment at some point over the next 12 to 24 months where growth stalls…some leading AI stocks stand the chance of sustaining steep pullbacks."* Immediately thereafter he references CSCO, a company that dominated in the 1990's and sits below its all-time high 25 years later.

In our mind, if AI succeeds as the markets are pricing, it's not a niche theme investment, but one that spans the entirety of the market. Rather than predicting the winners, we believe investing in great companies will garner the growth results we seek.

Calamos' Michael Grant doesn't argue that the AI leaders are great companies doomed to fail. Instead, he summarizes it this way *"…financial markets have become enthralled by the AI narrative and its widely touted promise to transform 'everything.' The major technology leaders have responded with a ~$1 Trillion spending plan on AI-related capex…History argues that today's AI spending boom is unlikely to avoid the misallocation of capital that typically accompanies celebrated investment narratives."*

It doesn't have to end in a bubble, but it's wise to consider the possibility! In the first half of 2024 the market cap gained by AI-associated companies equates to 15% of nominal GDP! That's 4% more than the Tech leaders of 1999 garnered for the full calendar year at the end of the Tech Bubble era.

Why should I own all these "boring" industrials and energy positions?

Trees don't grow to the sky! All good things must come to an end. Whatever cliche you choose, history suggests the recent manic behavior of AI-related investments will

likely pause (if not reverse course). We saw it in the Nifty Fifty, Tech Bubble, the '07 real estate bubble, the SPAC and the meme-stock bubbles. As we've repeated throughout this newsletter, ***it isn't that the AI leaders aren't great companies (they are)…it's simply a measure of price and value that concerns us.***

So how does one counter the valuation concerns associated with mega cap technology stocks? Boring, dividend paying, blue chip leaders is one way. The Energy sector trades a forward P/E 2.5x less than the technology sector and carries a 3.1% dividend yield. Materials and Industrials trade at 2/3 the P/E of tech. Both lower starting valuations and growing dividends can be a source of resilience for investors.

Furthermore, if the AI buildout, the Green Revolution, and a focus on energy and industrial independence continue, we will need to build a lot! Those sectors listed above are likely beneficiaries of a lot of government and private sector spending in the years ahead. Throw in two wars and a world filled with populist movements and it's also easy to see a need for defense spending to continue.

Market leading companies have rewarded investors for decades, regardless of sector. Names like Costco and Chipotle are examples of great companies in tough industries that have also been good investments. There's room for such holdings alongside the tech names that have dominated the 2024 narrative so far.

Is everything overpriced? Are we not in for a huge correction?

While the S&P 500 posted a +15.29% first half, the equal-weighted index was up 4.96%. There are undeniably pockets of stocks that trade at nosebleed valuations…but not all stocks are expensive. Furthermore, great companies who perform can (and often do) demand a premium valuation. It's when those companies miss the mark that the stock feels pain.

As we look across the landscape, we see segments of the market that offer growth at reasonable valuations. Their prospects don't project 30-50% returns annualized, but a more "normal" 10-15% potential. There are names that have provided double-digit EPS growth for decades that still trade at reasonable prices. Small caps are cheap (some for good reason). International dividend payers are cheap (and have been for 15 years). Chinese equities are inexpensive (and domiciled in a communist country).

Over the last decade the R1000 Growth index has outpaced the R1000 Value index 333% to 128%. Will this continue? Perhaps…but odds suggest an inflection somewhere down the road.

It is our belief that NOT everything is overpriced. We see pockets of "cheap" assets but stepping into any of these may cause a bit of restlessness as one pulls the trigger to buy. It's natural to feel anxiety buying something cheaply because in that moment there's a greater fear of a cheap stock failing than one thriving (at the time of purchase). We aren't advocating "bottom-fishing" for bad businesses, but instead continuing to allocate to out-of-favor good businesses.

The last 5 years have been an anomaly, and 20% returns are not the historical norm. To suggest it's different this time seems naïve and ignores the lessons of history. Generating consistent growth well above the risk-free rate is both attainable and expected. Strategies that have tracked the market fully on its ascent are, by definition, those exposed to an uncomfortable ending.

Staying disciplined will pay off…it's the timing that's the toughest part! ***It's different this time has yet to be proven true…More people saying it louder doesn't make it true!***

TACKLING THE BOND MARKET…NO GUESSING

Speaking with professional managers and economists weekly, it often seems like they are trying to convince themselves of the narrative they are telling about bonds. Tales most often start with some version of "history has shown" or "the last time" and end in flimsy logic. **While investing always has an element of educated guessing, we stand by the belief that bonds should be more about math than fortune telling.**

Why shouldn't I keep rolling Treasuries or CDs?

This goes back to the fortune telling parallel above. By holding an outsized weighting to cash-like instruments indefinitely, an investor is making a timing decision. With outsized yields and an inverted yield curve, we understand the temptation. We have, in fact, modestly overweighted short duration Treasuries over the last 3+ years to nice results.

Now, given the reasonable possibility that the Fed embarks on a rate cutting cycle in the coming months, we believe it's time to start locking in yields for longer. Repositioning doesn't have to be an all-or-nothing proposition. We have been adding duration from maturing Treasuries for 10+ months now.

The proof is easily shown by looking at our fixed income results. In 2023 cash outpaced the AGG until the last 6 weeks of the year. At the midway point of 2024, cash once again leads the AGG. Our fixed income portfolios outpaced the AGG by 3-5% in 2023 and lead the AGG by 4-5% mid-year in 2024. **No more guessing!**

If the economy is slowing, why should I own credit-sensitive bonds?

Today's bond environment is set to be among the best in decades. The Fed is on the precipice of cutting rates, businesses and consumers continue to hold up well, and absolute yields sit near decade highs. Couple that with tight underwriting standards, prudent Covid refinancing by corporate America, and most bonds still trading below par. This recipe makes owning a combination of fixed income assets (beyond US Treasuries) quite appealing.

How appealing? We own managers in the securitized arena (think home loans and car loans) who posted double digit returns in 2023 and are on pace to duplicate that in 2024. Our high yield corporate manager is on a similar trajectory after +12.51% in 2023.

For point of clarification, we own below investment grade bonds in the portfolio, but NOT passive strategies. Our managers do credit research daily to deliver the results that have earned our business. We monitor those managers on a regular basis for our clients.

Owning managers like those referenced allows the opportunity for outsized fixed income performance (and helps reduce the demands on the equity portion of one's portfolio. **Bonds are arithmetic! One can argue stocks are more akin to multi-variable calculus.** With stocks, there are a lot of if/then variable one must consider. With bonds the variables are time, price, and credit.

If the Fed's nearing its first cut, should I start to add duration?

We have been adding duration for 10+ months! The AGG has a duration of ~6 years and we now sit ~3.2 years on average. Moving toward 6 years, in our opinion, requires complete conviction that the Fed will be cutting aggressively (faster and further than the consensus opinion). We see little to suggest this is a good bet. Instead, we prefer to sit in a fixed income blend that offers an attractive yield (cash flow), trades at a discount to par and offers some price participation in the event of Fed cuts. The scenario that results in the AGG putting up "huge" numbers is one where the bottom falls out of the economy and forces the Fed's hand to cut aggressively. Otherwise, a gradual cutting cycle like Yellen embarked on in December 2015 or anything akin tr it suggests greater flexibility (and lower duration) is beneficial. That flexibility remains essential as we move forward from here in an ever-changing world.

DON'T TRY TO SELL ME ON INTERNATIONAL…

Rather than a sales pitch on the asset class many investors love to hate, we have simply listed a few reasons this 15-year laggard is worth a consideration and an allocation. In no particular order:

1. Yield more than twice that of US equities

2. Valuations well below similar US businesses that can allow for multiple expansion at a time when US valuations are "full"
3. European and some EM countries have already embarked on policy easing (whereas most assume the US remains a few months away)
4. Global tourism sparked by Covid stimulus and the pent-up demand for travel proportionally benefit Europe more than the US (as % of GDP)
5. EPS growth estimates for the MSCI for '25 and '26 are only modestly lower than US markets (yet higher dividends and lower valuations persist)
6. The sector mix of non-US equities (especially lower tech % weighting) could be a ballast if there's a reversal in the tech-driven rally of the last 18 months
7. European and Asian equities are far less covered by Wall Street analysts, allowing for skilled researchers to add value through security selection
8. US buybacks are at an all-time high and are likely near a plateau, whereas both Japan and Europe have significantly more room for buyback expansion
9. The S&P has outpaced the MSCI EAFE 230% to 53% over the last decade. Non-US equities have few "fans" and are as underinvested as they've been in decades.

While all the above make a case for owning non-US equities, none suggests how to time such an allocation. We don't have that crystal ball.

Most analysts we respect still have a US bias. We still have far greater weightings in US Stocks. Our inclination is to slowly add to an asset class that has remained out of favor most of the 21st century. Japan took over 30 years to make a new all time high…and is now Wall Street's darling again. A European renaissance is not that hard to imagine. We will continue to evaluate risk/reward across all asset classes…even those out of favor since before the Global Financial Crisis.

OH YEAH…THE ELECTION IS COMING…

While the US Election is far from an afterthought to any citizen these days, there's also little to rehash here that we haven't recently touched on. Elections historically serve as a source of market volatility often followed by a market rally on the finality/certainty of their outcome. Why should 2024 be assumed to not be a similar story when it's written?

Among the most significant impacts of the 2024 election are the composition of the US Supreme Court (2-3 justices potentially), Fed Chairman (possibly), Trump Tax cuts (extend or sunset), and management of a growing US debt load. What about entitlement reform? This one seems like a "don't touch" for both parties.

Given the concerns about President Biden's health and the assassination attempt on President Trump there's no denying that there will be some political drama ahead.

We will conclude as we did in Q1. **Buckle up!**

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