Don’t fall in Love with Stocks! Valentines Edition

Feb 15, 2024 - Client Update

Good afternoon,

I hope that everyone had a nice Valentines Day, had an opportunity to appreciate their family and loved ones, sneak in a few chocolates, and enjoy the day ☺

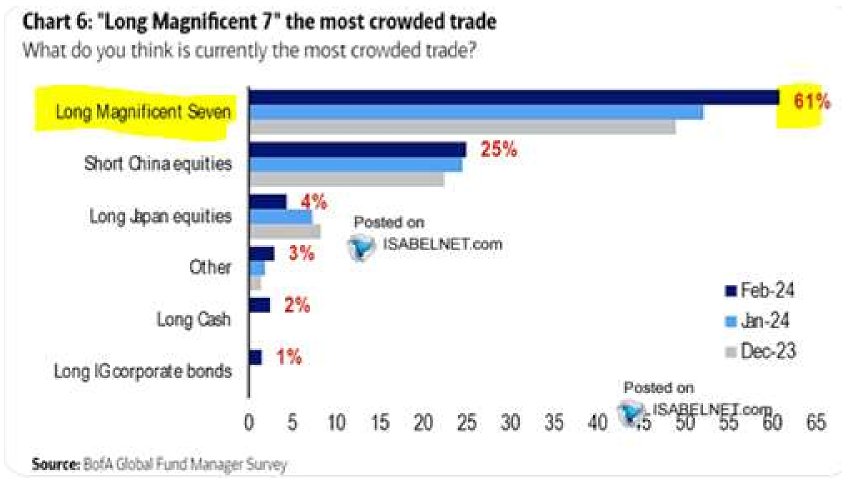
We are already halfway through the month of February and time is flying by! After a strong recovery in the markets in 2023 (*MPA Model Portfolio’s were up between 9% and 11% on average net of fees*) this years’ investment returns are off to a strong start as well (*up 3.75% to 4.5% so far*). However, there is a *love affair* brewing in parts of the market, that is worthy of mention.

Several years ago, a group of companies called the **FAANG** (Facebook, Amazon, Apple, Netflix, Google) were the leaders of the markets, day-in and day-out. There was definitely a crush that developed in those companies. I had commented on them in the past, and warned of the risk of a narrowly focused strategy. At the time, a lot of the money chasing markets would funnel into these companies because they were well known and generating strong returns for investors. However, as we went through 2022, a majority of these companies fell on average 50% from their peak price levels (*Meta/Facebook fell over 80% and Netflix fell 75% from their peak before finally finding a bottom!*).

Eventually, the financial media stop focussing on this group of companies, partly due to the change of a few of the companies names, (Facebook change their name to Meta, Google changed the name to Alphabet), but more so due to the disappointed investors and returns that weren’t worthy of attention.

Fast forward to 2023 and the new group of "heart throbs of the market" are called **The Magnificent Seven.** These companies rose up from the ashes in 2023, posted enormous returns, and became the new talking point to help engage investors to get back into the market and participate.

These companies include some of the former "FAANG". They are **Apple, Amazon, Alphabet, Meta, Microsoft, Nvidia, and Tesla**. The intrigue of quick gains and outsized riches, will even draw in the most sophisticated of investors. This time is no different. The chart below illustrates how crowded investor allocations to these companies has become.



The current time of year is actually quite interesting as investors seem to have fallen in love with owning these mega cap companies, without considering that getting into an investing relationship at this point in time may just lead to a broken heart and loss!

Now this isn't to say that participating and investing in a company that is doing exceedingly well is a strategy to avoid. When only a handful of companies are contributing to the performance of the market, you must have some exposure in your portfolio. However, if doing so, the strategy must be to focus on trimming profit on the way up, and then being prepared to exit these investments when the shine of the current market jewels begin to fade. For those interested in details, I provide an example.

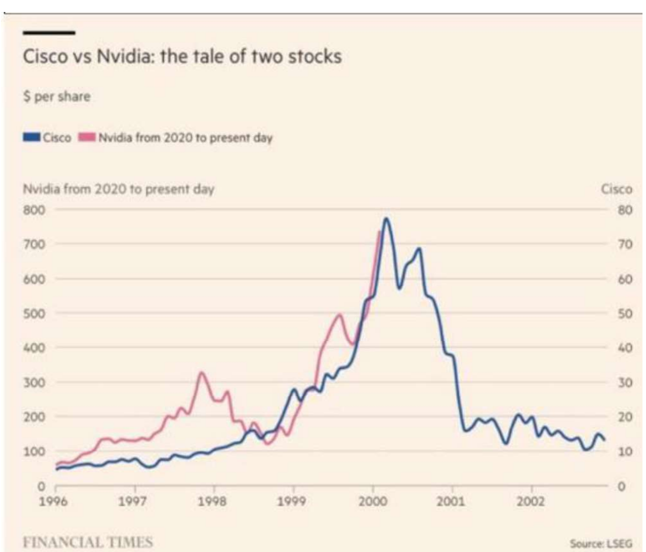
An example of owning the "winners", but minding the potential downside risks can be illustrated by the history of ownership in Nvidia in your portfolio. Initially Nvidia was added on July 2021 at $183. In November 2021, I trimmed some gains and sold at $314 (71% gain). As 2002 turned down, the remaining were sold at $213 in April 2022. A month later the shares had fallen further and the company looked ready for recovery. Shares were bought back at $178. But as we now know, 2022 was to be one of the worst years in a decade, and by October the full force of the 2022 drop was in play. Additional shares were bought at $125. One month later the full position was sold on a 20% bounce at $146. In January 2023, the recovery was looking stronger than only a late 2022 bounce, so the shares were bought back at $204. By July 2023 the shares were trading above $400, and gains were trimmed at $455 (more than a double in 6 months!). In August 2023 it looked as though we were hitting a peak and the rest of the shares were sold in August at $409 (an 8 month double). The shares traded sideways from there into years end, but as the Magnificent 7 continued being the focus, and with strong earnings in the Technology space, Nvidia started to rally and break out. Therefore, a position was re-entered at $563 in mid-January, and profits were already taken two weeks later at $673. The shares are currently over $730 and climbing. I expect to continue to trim gains and likely once again will exit completely.

Recently in client review meetings, I share the following two charts that illustrate how it is key to focus on longer periods, particularly when evaluating the "hot" investments. As shown below, you can see the **Magnificent Seven** having a wonderful run in 2023. However if you look back to 2022, these seven companies fell 50% and lost half of their value. Will the Magnificent Seven continue to lead the market this year? Exuberance can last for sometime, however, I am not investing your portfolios to be dependent on these companies for your returns. You have modest exposure to Tesla, Microsoft, Nvidia and Alphabet, but this is only 7% of your overall portfolio

Charts are as of December 29th, 2023

Thinking again about how time fly's, I am now through my 23rd year working in the investment industry! In my final year of University I completed a co-op at Merrill Lynch. It was the peak of the technology boom. I can recall doing finance portfolio projects at the UofL, investing in the "Nvidia's" of the day. Companies like Sun Microsystems, Juniper networks, Cisco Systems, and Oracle. I thought I was really smart by the amount of money being made, only to later realize investors had become obsessed with mega cap technology stocks. I learned early on what it was like to watch a market tumble, which influences my risk management to this day.

Today we are approaching a similar scenario, and it **breeds caution** and is the reason for this update. Below are two illustrations using Nvidia, on where we are at in the excess priced into some of these companies. On the left, the price rise of Nvidia is overlayed with Cisco from the 1999-2000 peak, and while Nvidia's future is uncertain, it paints a scary picture! On the right is a chart that shows how Nvidia is worth more than ALL of the US Energy Sector companies values combined, even though the Net Income of those Energy companies are almost 8x higher than Nvidia!



S&P 500 Energy Sector ETF ($XLE) vs. NVIDIA ($NVDA)

Ticker	Name	Market Cap ($Billions) As of 2/9/24	Net Income (TTM, $Billions)
XOM	Exxon Mobil Corp	404	36
CVX	Chevron Corp	280	21
COP	ConocoPhillips	131	11
SLB	Schlumberger Ltd	67	4
EOG	EOG Resources Inc	65	8
PSX	Phillips 66	63	7
MPC	Marathon Petroleum Corp	63	10
PXD	Pioneer Natural Resources Co	53	5
OXY	Occidental Petroleum Corp	50	5
VLO	Valero Energy Corp	49	9
HES	Hess Corp	44	1
WMB	Williams Companies Inc	41	3
OKE	ONEOK Inc	40	2
KMI	Kinder Morgan Inc	37	2
HAL	Halliburton Co	31	3
BKR	Baker Hughes Co	29	2
FANG	Diamondback Energy Inc	27	3
DVN	Devon Energy Corp	27	4
TRGP	Targa Resources Corp	19	1
CTRA	Coterra Energy Inc	18	2
EQT	EQT Corp	14	3
MRO	Marathon Oil Corp	13	2
APA	APA Corp	9	2
Energy Sector Totals ($XLE)		**1574**	**147**
Nvidia ($NVDA)		**1782**	**19**

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It is not only Nvidia however, as the two charts below are telling about the state of the narrow focus of todays market.

On the left, the chart shows the percentage of the performance in the S&P 500 being driven by the Semiconductor Index (just call it "technology stocks"). In 2000, 90% of the returns were driven by the Tech Sector. This declined rapidly after the Tech Bust, and for the next 15 years only contributed to around 20% - 30% of total returns (in line with their representation in the index). In 2024 we are now back at the 90% figure, making pure S&P 500 index investment (or investment in Funds that mimic the index) at risk to decline and disappointment.

On the right, the chart illustrates the percent of stock market value accounted for by the top 10% of stocks in the market. We are now sitting at 75%, which correlate to 1930 and 2000!

If I was a betting man, I would say that **a strategy that avoids holding the biggest companies** would be the best option for the next couple of years, and **that is exactly what we are doing in your portfolio!**

To wrap up this update, I wanted to make sure that the investment strategy is clear to all clients. **There is significant opportunity for solid returns ahead in the market in my opinion**, and the portfolio is being managed to watch out for overvalued or hyped areas of the market. We can participate in some of them, but we will not wear out our welcome. As money leaves these over-done companies in the coming years, I believe the other sectors of the market will be the recipients of investment dollars.

When I started in this industry over 20 years ago, the shift out of technology went into sectors that do well during inflationary times. Mainly materials, energy, industrials and discretionary companies. That is how we are positioned in your portfolio, as history doesn't always repeat but it most definitely rhymes! Enjoy the rest of the week.

Take care,

Ryan

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