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COMMODARI ANTINORI GROUP / BMO NESBITT BURNS

INVESTMENT COMMENTARY: SPRING 2023

"It's silly to try to escape other people's faults. They are inescapable. Just try to escape your own."

– Marcus Aurelius

Financial markets rebounded remarkably in recent months, following a tumultuous year. Despite the challenges of persistently high inflation, rising interest rates, the ongoing war in Ukraine, and sharp geopolitical tensions, investors have begun to anticipate a brighter future, and financial markets have made gains.

For the six months ending March 31, 2023, the total return of the S&P/TSX Composite Index was 10.81%, while the S&P 500 Index and MSCI World Index gained 13.10% and 16.30% respectively. Over the same period, the FTSE/TXM Canada Bond Universe, a fixed-income benchmark, returned 3.31%.

We have seen some of the worst performers of 2022 make a strong comeback, with a renewed sense of risk-taking gripping the markets, as evidenced by a soaring NASDAQ and a resurgence of the ARK Innovation Exchange Traded Fund (ARKK EFT). Please read on for more thoughts on ARKK EFT and for our reflections on recent market developments, portfolio positioning, and risk management.

COPE WITH SHORT-TERM UPHEAVAL FOR LONG-TERM SUCCESS

Given the stellar short-term performance of financial markets, investors may wonder whether they should "take their money and run." There remains so much uncertainty, after all. They would be forgiven for wondering if they would be better off selling now and waiting until the outlook is clearer.

We believe that no one can presume to know what's next, nor accurately time the markets. For investors to assume that they can predict the markets is one of the most common mistakes they make. We cannot stress this enough. Numerous studies have shown that investors who attempt to "time" the market frequently end up with lower returns than those who hold their investments for the long term.

We encourage investors to concentrate on their long-term financial goals and develop sound investment strategies that align with those goals and their risk tolerance. This is our forte at Commodari Antinori Group – helping our clients develop a unique *Investment Policy Statement* and apply our time-tested and market-proven investment approach to steer through short-term volatility and market fluctuations. Staying invested in a well-diversified portfolio that aligns with financial goals and risk tolerance is a far more reliable approach to growing capital than trying to outsmart the markets.

EARNINGS: A GREAT SHOCK ABSORBER AND CAPITAL MULTIPLIER

Investing can be a lucrative way to grow your wealth over time, but to be successful requires level-headed thinking and sound strategy. A key component of a successful investment strategy is having a *buying discipline*, which means being mindful of the price you pay for a stock and avoiding the temptation to invest in popular stocks regardless of their share price. This is one of our competitive advantages: the application of a well-defined buying discipline.

To illustrate the importance of price discipline, let's revisit two baskets of stocks, Group 1 and Group 2, that we first introduced in a video last Spring.

SCAN ME

At the end of 2021, the stocks in Group 1 had a combined market capitalization of $1.5 trillion and earnings of $2 billion, while those in Group 2 had the same $1.5 trillion market capitalization but earnings of $67 billion . In other words, for the same price, Group 2 gave you 33 times more earnings than Group 1.

GROUP 1		GROUP 2	
As At December 31, 2021		*As At December 31, 2021*	
Market Capitalization	$1.5 Trillion	Market Capitalization	$1.5 Trillion
Earnings	$1.9 Billion	Earnings	$67 Billion
As At April 17, 2023		*As At April 17, 2023*	
Market Capitalization	$729 Billion	Market Capitalization	$1.4 Trillion
Earnings	$1.5 Billion	Earnings	$68.3 Billion

Fast forward to a little over one year later, and the market capitalization of Group 1 has plunged more than 50% and earnings dropped 21%, while Group 2's market capitalization declined a comparatively modest 11% and earnings *increased* slightly to just over $68 billion dollars.

These actual performances highlight the importance of paying attention to the fundamentals of a stock, especially its earnings, as earnings provide a backstop to stock prices. A company that is generating strong earnings is likely to have a stock price that is more stable and less susceptible to market volatility.

In the case of Group 1, it appears that investors may have been drawn to the popularity of its stocks without considering their underlying earnings. As a result, the market capitalization of Group 1 suffered a significant drop, indicating that the share prices were not sustainable. On the other hand, investors who were more disciplined in their buying approach and focused on stocks with strong earnings, as evidenced by Group 2, experienced a small drop in market capitalization.

Although both baskets had the same market capitalization at the end of 2021, the earnings of Group 2 were significantly higher. This meant that Group 2 had a stronger foundation to support its stock prices, even in the face of market fluctuations. In contrast, Group 1's meagre earnings couldn't support its stock prices, leading to a significant drop in market capitalization.

Earnings provide a backstop to stock prices and are critical in weathering market volatility and economic downturns.

That's why we do not get caught up in the hype of popular stocks, and we ensure that we invest in companies with strong owner earnings and reasonable valuations.

WHEN HYPE LEAVES INVESTORS TREADING WATER

ARKK has been one of the most talked-about ETFs in recent times. Its fund manager's reputation for her visionary investment strategy that focused on disruptive technologies, such as electric vehicles, artificial intelligence, and biotechnology, had resonated with a wide audience. Fuelled by hype surrounding these nascent industries, ARKK ETF gained immense popularity among investors. Its assets grew from $1.4 billion at the end of 2019 to a peak of $28 billion in February 2021. Sadly, investors were soon disappointed. Since its peak, the fund has lost more than 75% of its value.[1]

ARKK's crushing decline coincides with a rise in interest rates, which inversely affects all asset prices, especially financial assets. Generally, when interest rates rise, asset prices fall. Thus, the fund's large concentration of high-growth stocks became a liability when investors started worrying about the sustainability of their growth rates and, without meaningful earnings to backstop the share prices of its portfolio holdings, ARKK's value plummeted.

Both the rise and the fall of ARKK are reminiscent of past financial manias, when investors were swept up in the hype surrounding the latest investment craze, such as the dot-com bubble of the late 1990s and the housing bubble of the mid-2000s. In both cases, investors were drawn in by the promise of quick and outsized returns, only to see those gains evaporate when the bubbles burst. Similarly, ARKK promised investors the potential for high returns from innovative and disruptive companies, but the reality turned out to be much different.

Fred Schwed's book, Where Are the Customers' Yachts?, is a humorous and satirical critique of Wall Street and its practices. Its theme is that investors often make poor decisions based on faulty information and are taken advantage of by financial professionals who are more interested in making money for themselves than for their clients.

Originally published in 1940, the book tells the story of a visitor to New York who sees the luxurious yachts owned by Wall Street bankers and asks, "Where are the customers' yachts?"

Some financial experts see ARKK as a modern-day example of this phenomenon. Many investors rushed to invest in the fund when it was up over 700%, pouring in more than $3 billion in assets in its best-ever monthly inflow near the peak.[2] ARKK's management fees are twice the average of actively managed ETFs, and the fund's management earned more than $200 million in fees, while its investors saw their investments lose more than $10 billion.[3] It's interesting that the bulk of these fees were booked after the peak!

In 2023, a visitor to Wall Street in Lower Manhattan might conjure up Noah and ask, "Where are the customers' ARKKs?"

OUR BEST ADVICE: BANISH EMOTIONS

Financial markets are inherently unpredictable. No one can predict the direction of the economy and financial markets. We want to emphasize the importance of staying calm and level-headed in the face of uncertainty and not allowing emotions to cloud your investment decisions.

It's important to understand that uncertainty is an inescapable aspect of the investment landscape. There are always factors beyond our control, such as changes in economic policy, geopolitical risks, natural disasters, and even pandemics. We cannot foresee these events with certainty, but we can prepare for them by maintaining a diversified portfolio that can weather various market conditions.

When faced with uncertainty, it is natural to experience a range of emotions, such as fear, anxiety, and panic. These emotions can lead to rash decisions and impulsive actions, which can ultimately hurt your investment returns. For example, during times of market volatility, it is common for investors to sell their investments out of fear, only to miss out on potential gains when the market recovers. Similarly, when the market is soaring, investors may be tempted to buy into stocks at high prices, only to realize that they have overpaid.

Part of our role at Commodari Antinori Group is to help our clients memorialize their unique objectives, constraints, and risk tolerance in an *Investment Policy Statement* to remove emotions and promote rational, data-driven decisions. By staying disciplined and adhering to a long-term investment strategy, you can weather short-term market fluctuations and stay on track toward achieving your financial goals.

PORTFOLIO DEVELOPMENTS AND COMPANY SPOTLIGHT

Equity markets in early March 2023 were rocked by the rapid implosion of a California- based regional bank, Silicon Valley Bank. Fears percolated that a new contagion was brewing, sending most financial stocks lower, several dramatically so. We used weakness in this space to top-up several positions and add a new one. More on this in our mid-year client reports.

A longer-standing holding, British multinational Rolls-Royce Holdings Plc, has had some wind beneath its wings. Rolls-Royce is an aerospace, defence, and energy company headquartered in Derby, England. It is one of the world's largest aerospace companies and a major player in the defence and energy sectors.

Rolls-Royce's financial performance has been mixed in recent years. The company has been hit by several challenges, including the pandemic, the global economic slowdown, and the ongoing trade war between the United States and China.

Despite these challenges, Rolls-Royce has made some progress in recent quarters. A new Chief Executive Officer, Tufan Erginbilgic, is intent on reinvigorating the company. In the first half of 2023, the company reported revenue of £10.2, up 10% year-over-year. Earnings before interest, tax, depreciation, and amortization (EBITDA) were £1.2 billion, up 20% year-over-year.

Rolls-Royce's performance in the first half of 2023 was driven by strong growth in its civil aerospace business. A key benchmark for this segment, engine flying hours, is at 80% of pre-COVID levels. The company's order book for civil aircraft stands at £104 billion, which is the highest level in its history[4].

Rolls-Royce is also benefiting from the recovery in the global economy. The company's defence and energy businesses are seeing increased demand from customers around the world.

Although unexpected turbulence is possible, Rolls-Royce's overall financial performance is improving. The company is making progress in its turnaround efforts and is well-positioned to benefit from the recovery in the global economy. We are content to practice patience as we wait to be adequately rewarded.

CONCLUDING THOUGHTS

Restrictive monetary policy, sticky inflation, a weakening consumer, and declining manufacturing activity are the top stories in various media. Tightening lending standards following the March 2023 banking crisis is a recent addition that further complicates the outlook. Risks appear further skewed to the downside than the upside, given the potential headwinds to earnings. One caveat is that markets discount information quickly, and many of the concerns we have outlined are well known. If economic data and corporate earnings are simply less bad than feared, asset prices may yet react positively in coming months. Of course, geo-political events will certainly create unforeseen dislocations.

How events will unfold is really anyone's guess – a parlor game at best. Yet, many investors succumb to this distraction, it's a natural fault. As Marcus Aurelius observed: let's not fall prey to our faults. Time is better spent assessing the prospects of our companies and, preparing to pounce when opportunities present themselves. We remain steadfast that our businesses will endure and thrive in the years ahead. Thank you for your confidence.

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"The Commodari Antinori Group of BMO Nesbitt Burns offers a boutique private client wealth management experience. We work exclusively with high-net-worth individuals and their families and build for them unique portfolios — no pooled funds or other proprietary products."

Let's connect
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[1] *Financial Times, March 23, 2023.*
[2] *Ibid.*
[3] *Ibid.*
[4] *Company Reports, February 23, 2023*