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COMMODARI ANTINORI GROUP / BMO NESBITT BURNS

INVESTMENT COMMENTARY: FALL 2024

"What you don't play can be more important than what you do."

– Thelonious Monk, American jazz pianist and composer

Financial markets performed well over the past six months, as inflation subsided, and central banks eased interest rates. Indeed, in a long-anticipated move, the Federal Reserve in the United States shifted its stance towards rate cuts, with a notable 50 basis point cut in September, the first since its last hike 14 months prior.

It is no surprise then that the strong bull run in most equity markets, which began in 2023, continued its advance with only a few hiccups – the usual suspects: geopolitical tensions and recession worries.

For the year-to-date period ending September 30, 2024, the total return in Canadian dollar terms for the S&P 500 Index and MSCI World Index were 24.60% and 21.74% respectively, while here at home, the S&P/TSX Composite Index gained 17.24%.

Over the same period, backed by a solid performance at several of our businesses, portfolios managed by Commodari Antinori Group delivered stellar results. As always, intrinsic value remains our measuring stick and so, on that metric, we have been accumulating cash to fund future opportunities. Moving forward, that cash will likely act as an anchor on short-term results.

The great American jazz pianist and composer, Thelonious Monk, captures the essence of our approach in the opening quote of this piece. How and where we choose to play is important! Our style of investing is rational, calculated and patient so we will carefully pick and choose where we invest your hard-earned money and where we won't. We like it when the risk-reward equation leans strongly in our favour and prefer to pass on investments that are in the *too-hard to tell* pile.

VALUATION MATTERS

In a familiar pattern for nearly two years now, a handful of stocks known collectively by affectionate monikers, the Magnificent Seven and AI Fab Five, have driven the stock market's charge higher.

With only a few stocks moving the needle on indices, it is no surprise that the stock weightings of supposedly "diversified" benchmarks, such as those of the S&P 500, have reached absurd levels. Today, this index, although comprised of 503 constituents, has 31% of its value concentrated in just its top six names. If that is not radical enough, consider the Russell 1000 Growth Index. This index is currently made up of 440 stocks, and the same top six stocks make up 50% of this benchmark.

Balancing risk and reward and keeping emotions in check are not easy tasks. They are even harder in ebullient markets like todays. After all, who doesn't like a party? While everyone loves portfolio gains, nobody likes losses, and these are loathed and more acutely felt than gains.

At Commodari Antinori Group, we take emotion out of the equation. We believe that valuation matters, and we remain bottom-up stock pickers as we have been for over 28 years.

A rationale framework guides our investment decisions. Our goal has never been to beat an index, but rather, to ascertain value and buy one good company at a time when we deem Mr. Market is offering up real value and prices are in our favour. Short of the latter, we allow cash reserves to rise as we wait for opportunities to present themselves.

DO MORE WITH LESS

A big contributor to stock market advances in the last decade has been the growing popularity of passive investing via Exchange Traded Funds (ETFs). We first wrote about this phenomenon in our January 2017 Investment Commentary (Buyer Beware) and again in July 2018 (Exchange Traded Risk).

Back then, per Morningstar, assets invested in passive instruments totalled about $4 trillion. Today, according to Bloomberg, that sum bas ballooned to more than **$30 trillion** – and continues to grow by billions per day. Alarmingly, Bloomberg also notes that as little as 15 months ago, the NASDAQ 100 had a market valuation just over $12 trillion whereas today that number surpasses $24 trillion!

Our perspective remains unchanged. What started as a good idea when John Bogle pioneered index investing in 1976 has been carried to an extreme and drifted far from its original purpose of providing investors with the ability to own a diversified basket of stocks at relatively low-cost.

Sadly, today many ETF's have little in common with John Bogle's pioneering fund and we fear that what was once sound medicine may ultimately prove to be quite harmful as ETF's do little to encourage price discovery and inflate assets indiscriminately. Recently, *The Globe and Mail* reported that 23 ETFs in Canada are linked to the performance of a **single** stock, such as Nvidia or Tesla. Many are now using leverage to magnify returns, placing bets on things like the direction of the stock market, gold or interest rates! And, if that was not bad enough, as of August 30th, 2024, 1,027 ETFs were trading on the Toronto Stock Exchange, dwarfing the number of listed stocks.

The downfall of indexation is the complete absence of any valuation strictures or discipline. A key feature of any market, *price discovery*, is ignored. Today, of every new dollar allocated to an S&P 500 Index fund, thirty-one cents goes into just six stocks – regardless of valuation. This is fine so long as markets are moving higher but, when a tipping point comes – as it always does – and markets head lower, there will likely be a rapid unwinding of positions in turn, putting more downward pressure on stock prices. This is what happened in the early months of the COVID-19 pandemic, in February and March 2020.

We wrote in July 2018 that "*the proliferation of ETFs is simply the latest manifestation of Wall Street's well-worn tendency to encourage trading and excessive risk taking*." In our view, things have gotten worse.

The availability of so many premium-priced, exotic ETFs, along with the practices of online brokerages, has served to **degrade** and **devalue** investment. A serious endeavour is being turned into a game. So much so that regulators have shone the light on this matter to protect the public. Last week, the Ontario Securities Commission released a report entitled *Gamification Revisited: New Experimental Findings in Retail Investing*. This study identified many emerging digital engagement practices, such as leaderboards, copy trading and social interactions, and other features that encourage trading and have the potential to harm investors.

For us, investing is and always will be a serious endeavour. It's not a game. We believe that to improve the odds of outperforming any benchmark over a long-time frame, an active equity manager must build a portfolio that looks different from its respective peers and associated benchmarks. That's why we invest in only 30 or so stocks.

We find it ironic that our focused portfolio is arguably as diversified (if not more) than benchmarks that carry hundreds of stocks. Moreover, collectively, our portfolio of businesses trade at a lower multiple than the S&P 500 and so, have returned more with less – risk that is.

AI: ASPIRATIONAL INVESTMENT

Throughout history, financial markets have witnessed bubbles fueled by the desire for quick wealth. These speculative frenzies – such as the Tulip Mania of 1637, the South Sea Bubble of 1720, and the dot-com bubble of the late 1990s – are united by a common thread: the aspiration to turn small investments into fortunes. However, these manias have typically ended in financial disaster, as mass optimism and inflated expectations clouded rational judgment.

The Tulip Mania in the Dutch Golden Age is often cited as the first recorded speculative bubble. Tulip prices skyrocketed as demand for rare bulbs surged, with some selling for more than houses. Investors hoped to capitalize on the increasing prices, only for the market to collapse in 1637, leaving many ruined. Similarly, the South Sea Bubble of 1720 saw investors pouring money into the South Sea Company, lured by promises of untold riches from trade with South America. Stock prices inflated well beyond the company's true value, driven by greed and euphoria. When reality hit and investors realized the company's prospects were limited, the bubble burst, devastating fortunes across England.

Fast forward to the late 1990s, and the dot-com bubble showed how new technology, much like tulips and South Sea ventures before it, could drive investors to irrational exuberance. Investors flocked to internet-based companies, often with little regard for actual business fundamentals or profitability. As prices soared, so did expectations, but once it became clear that many of these companies would not live up to the hype, the market crashed in 2000, wiping out trillions of dollars in value.

A recurring element in all these bubbles is the human tendency to believe that "this time is different" and that wealth can be generated effortlessly. The desire to get rich quickly blinds investors to fundamental risks and leads to speculative excesses. Rather than view assets with caution, investors chase rising prices, confident they will sell at a profit before the bubble bursts. This behaviour creates a vicious cycle of overvaluation, which inevitably collapses when reality sets in.

Today, the rise of artificial intelligence has sparked a new wave of speculative enthusiasm. Although AI has the potential to revolutionize industries, the fervour surrounding it resembles past manias, where valuations become disconnected from underlying realities. Investors, driven by dreams of AI-fueled fortunes, may be underestimating the time it will take for these technologies to mature and deliver tangible profits. As history has shown, when euphoria replaces sober analysis, financial bubbles are likely to form, often with painful consequences.

While innovation and new technologies will always inspire investment, history reminds us to approach such enthusiasm with caution, lest we repeat the mistakes of the past. *Caveat emptor!*

MIXING POLITICS & PORTFOLIO MANAGEMENT – AVOID!

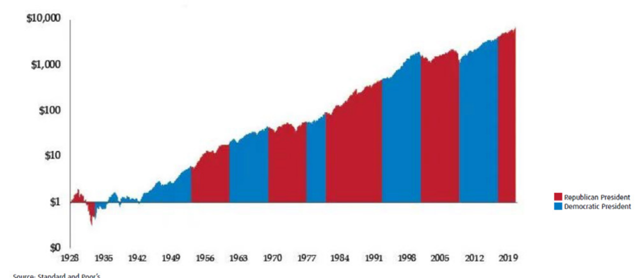
As election season heats up, many investors feel the urge to adjust their portfolios in anticipation of a particular outcome. Whether motivated by fear or hope, it can be tempting to make moves based on perceived policy shifts that might follow the election of one candidate or another. However, history shows that mixing politics and investing has a poor track record.

The markets have endured dozens of election cycles, each accompanied by its own set of troubling headlines. Yet, over the long term, Corporate America – and the markets that reflect it – have marched steadily higher. The resilience of the market is grounded not in political maneuvering but in corporate fundamentals and economic cycles. These factors drive company performance far more than who occupies the White House or controls Congress at any given moment.

Corporate progress, which ultimately influences portfolio performance, tends to reflect broader trends in earnings, innovation, productivity, and the global economy. Policy changes do affect specific sectors and industries, but these impacts unfold gradually. There will be ample time to digest and adjust to any post-election shifts in policy once the new Congress and administration take office in early 2025.

Although political developments can add to market volatility, we firmly believe they rarely alter the long-term trajectory of well-diversified portfolios. Investors are better served by focusing on corporate fundamentals and broader economic indicators rather than trying to outguess election results. Patience, discipline, and a clear investment strategy remain the best guides through election seasons and beyond.

As the chart below demonstrates, markets have adjusted and persevered, irrespective of which party was in the White House. As long-term investors, it is important to keep a sense of balance and perspective as we focus on the next generation, not the next election.



PORTFOLIO DEVELOPMENTS

There are no major changes to report – our top positions on September 30, 2024, remain almost identical to those at mid-year 2024. We are in "maintenance" mode, trimming existing positions as their weights continue to grow within portfolios and concurrently keeping a keen eye out for new opportunities, ready to pounce when they are identified. That said, we have not turned off the lights; we keep monitoring our stable of businesses. Here are observations on two of our holdings:

CarMax Inc. - Over the past nine months, CarMax (KMX) has faced challenges from a softer used car market and broader economic headwinds. Used vehicle sales for the fiscal year ending February 2024 fell by 5.2%, while revenues from used vehicle sales dropped by 9.2%. Similarly, wholesale vehicle sales were down by 16.9%, reflecting a decrease in vehicle affordability and a cautious consumer environment. Despite these declines, CarMax experienced some stabilization, with a slight increase in retail used unit sales (1.3%) in Q2 FY 2025. The company is investing in its long-term strategy, including expanding its reconditioning and auction capabilities and, planning $500-$550 million in capital expenditures for fiscal 2025. Unit sales should rebound gradually between fiscal 2026 and 2030, supported by operational growth and improvements in the used car market.

Alphabet Inc. - Over the past nine months, Alphabet (GOOG) has seen significant developments, including strong revenue growth driven by continued expansion in Google Cloud, which became profitable in Q1 2024. AI remains a key focus, with advancements in generative AI tools like Bard, integrated across Google services. Regulatory challenges have persisted, with ongoing antitrust cases in the United States and Europe, and Alphabet has made strategic moves to bolster its AI research capabilities through acquisitions and partnerships. In addition, cost-cutting efforts have continued, including workforce reductions, and improved operational efficiency.

A LOOK AHEAD – UNCERTAINTY PERSISTS

Uncertainty is a constant. Whether it's market competition, shifting consumer preferences, or regulatory changes, we have all navigated countless unknowns to achieve success. The same holds true in investing. Markets are unpredictable and, although we can analyse businesses and make informed decisions, there's always an element of the unexpected.

Successful investors, like business owners, embrace uncertainty rather than fear it. By focusing on long-term goals, maintaining flexibility, and staying disciplined in strategy, we can turn uncertainty into opportunity. After all, it's the unpredictable nature of markets that creates potential for growth and innovation.

Be assured that we are mindful of the efforts and sacrifices you have made to accumulate your assets. You can count on our diligence in protecting and growing your capital. 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."

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