JOPPA MILL ADVISORS LTD.

Investing is Difficult

July 2023

Investing is difficult, especially when you are responsible for managing other people's money. Aggregating and interpreting the myriad of data inputs influencing the price discovery function and the general tone of the market requires knowledge of those data elements, experience with the how they might be interpreted and observation of which interpretation is having the greatest impact on the direction of prices. Given the strong psychological influence on investors' behaviors and the markets' forward-looking tendency, the conclusions derived from the "data" can be at odds with the markets' direction. Technical indicators, fundamental analysis of balance sheets and income statements, financial ratios all can be rationalized away if there is sufficient psychological momentum pushing the stock market one way or the other. Moreso than most other occupations, your "performance" may be constantly compared with broadly disseminated "market indices", such as the S&P 500 Index. It is a natural human bias to want to make comparisons; however, while statements such as, "the market is up" or "the market is down", may be accurate observations over a given time period, they are naïve at best; there is so much more going on…! And then there is the other huge psychological motivator, FOMO (see May's *Grist from the Mill*).

As I described in last month's *Grist from the Mill*, FOMO, the majority of the S&P 500 Index return this year can be attributed to 7 or 8 stocks that are among the most heavily weighted in the Index AND have the tailwind of an AI affiliation. According to data sourced from Wealthcare Capital Management, the "Magnificent Seven" – Google, Tesla, Apple, Amazon, Microsoft, NVIDIA and Facebook accounted for approximately 80% of the year-to-date gains. Looking across the respective sectors, Information Technology, Communications Services ,and Consumer Discretionary, are all up more than 30% on the strength of AAPL, MSFT, NVDA, TSLA, GOOGL, META and AMZN.[i] This "Tech Plus" rally started as as reaction to the regional banking turmoil in March. This created an expectation for the Fed to ease rates in reaction to a potential liquidity/credit crisis. With NVIDIA announcing in May, substantially higher earnings guidance, the rally kicked into higher gear. With improving economic data, in June, the market gains began to broaden to more cyclical sectors, such as Industrials.

Traditionally considered "defensive" sectors, Utilities as a group returned -5.69% in the first half; Health Care returned -1.48%, and "safe haven" Consumer Staples such as Coca Cola, Proctor & Gamble, and Colgate broadly returned between -3% and +3% for the first six months of the year.[ii]

When one compares the S&P 500 (which is weighted according to the capitalization of the constituents) to an equal-weighted index consisting of the same S&P constituents, the performance differential is dramatic! Year-to-date equal-weighted S&P 500 Index return 6.93%; S&P 500 Capitalization-weighted Index return 16.9%[iii]

Performance in Context

We all like to "beat the market", but only a rare few have the financial wherewithal to have close to 100% of their money invested in stocks, yet that is exactly the asset allocation of the S&P 500 one is comparing to their portfolio. Along with this bold bet comes a mind-numbing volatility. The standard deviation of returns associated with the S&P 500 Index since 2000 has been approximately 18%[iv]. The annualized return over the comparable period is approximately 8%. Statistically, this means that 2/3 of the time, your return will fall between a 17.4% gain and a loss of -1.4%. To capture 99% of the statistical probability, that range of expected outcomes expands to +36.8 / - 10.9% in any given year! Of course, there are always aberrations in statistics, such as 2022 when the S&P 500 returned -18.1%!

For most investors with whom I work, this is an unacceptably high variance of potential outcomes and makes planning for the future extremely problematic. Consequently, our focus is on your long-term financial goals while providing you with a greater sense of confidence in successfully achieving those objectives. We want to reduce uncertainty in the things we can control. This is the significance of the Comfort Zone.

What am I thinking about?

The U.S. economy continues to plod along. Recent economic data is squeezing the recession narrative, although one should not completely dismiss the notion of economic slowing. Exactly when remains a question.

- Inflation is showing signs of continued slowing, although the Federal Reserve's favored gauge "Core CPE" – which excludes food and energy – is still hovering at 4.6%. We should see continued improvement as 8% and 9% monthly numbers from 2022 roll off the trailing 12-month calculation.
- Manufacturing appears to be stabilizing, although still at a contractionary level. Benefits from the Federal CHIPS and Infrastructure Acts finding are starting to emerge. Energy and transportation infrastructure as well as the movement to on-shore more manufacturing facilities are fueling interest in industrial companies.
- All I can add to the Artificial Intelligence conversation is that it will take longer than we expect to see deployment of AI noticeably enhancing productivity, which is, after all, the whole purpose!

The geo-political situation remains worrisome both in eastern Europe and Asia. Major wild card!

Interest rates will remain higher for longer.

- If there was any doubt, Chair Powell clarified the Fed's intent during his appearance at the European Monetary Summit last week. Expect more rate hikes.
- An inverted yield curve (2 year yields higher than 10-year yields) will continue to pressure banks. Attractive money market rates are causing dis-intermediation – where depositors withdraw deposits from banks in favor of higher yielding assets. The banks have less to lend out and it's more expensive.
- Lending standards are becoming tighter – the projects that made sense when they were funded with 3% loans often are uneconomic at 6% and 7% financing. Especially when the commercial real estate collateral now has a lower market value because nobody wants to go back to an office.
- The current administration is not what one might consider "business friendly". Specifically, there appears to be great reluctance to allow mergers or acquisitions to be permitted.
- Mandated "clean fuel" deadlines are totally unrealistic given the infrastructure and state of technology required for this to be successful.
- Policies promoting or expanding entitlements literally are counterproductive to the efforts to curb inflation (although very popular with the electorate!)

If, in fact, the "higher for longer" scenario results in the much forecasted "recession" – even if it is a "soft landing" - one might expect a scenario producing job losses, which inevitably force consumers to reduce discretionary spending. Looking only at the year-to-date performance of the Consumer Discretionary Index, there isn't even a hint of such a retrenchment with the Index up 33%. One might even think there is a resurgence in spending. In actuality, the Index consists of Amazon (24% of the weighting) and Tesla (19%), whose combined return year-to-date is over 36%![v] Does this revelation make you want to put money into Consumer Discretionary stocks?

None of us can control the market, nor do we have a crystal ball. The "A.I. rally" manifested quickly and has transfixed the investing public with spectacular returns among a relatively limited set of stocks whose representation in the Index distorts the reality of the market of stocks. It's also a wonderful narrative for the media.

Consider these potential investments[vi]:

1. Household name trading at 33x this year's earnings, with a 3-year earnings growth rate of 22%; yields 0.5% and has twice as much debt as they do equity on their balance sheet and heavily exposed to consumer spending?
2. Trading at 127x this year's earnings and 72 times next year's earnings, and; a 3-year earnings growth rate of 28%, with no dividend?
3. Household name that incurred an operating loss in 2022; stock is trading at 80x 2023 earnings estimates and 47x 2024 earnings estimates; no dividend; low single digit operating margins and heavily reliant on consumer spending?
4. The stock is trading at 10x 2023 earnings with a 3-year earnings growth rate of 53%; an operating margin of 22% and 30% debt.
5. Priced in the mid-$30's, the stock has a price/earnings ratio of 11x, a 3-year earnings growth rate of nearly 60% and a 4.5% yield?
6. U.S Treasury bill with a six-month maturity yielding 5.4% annualized?

Which investment looks the most attractive to you? High growth stocks, selling at valuations well in excess of their growth rates, such as #2 or #3 whose stock price reflects the anticipated future advantage of AI in their business?

How about #1, a well-known company whose products are ubiquitous, slightly cheaper than #2 or #3, but you are still trading at a premium for expected growth?

Then there are #4 and #5. Trading at a discount to growth rates, with attractive operating margins and dividend yield, but perhaps less influenced by the "hype".

And there is always #6 – safest, most liquid, attractive yield, even if it's only for 6 months.

In actuality, an investor would likely own more than one or two of these investments, or perhaps all 6, but how do you allocate your money among them? This then is where the touchy-feely, art-rather-than-a-science part comes in. Some investors need income now, others need to see steady growth in principal, still others think they can determine the best times to get in and out of the market to avoid large downturns and insist on focusing on absolute performance (irrespective of conventionally measured risk.) The one universal truth is that they all look to <u>preserve their capital.</u> Alas, risk and return go hand-in-hand. No return without some element of risk; known or unknown.

Joppa Mill Advisors Ltd.

So, with that in mind, which of the six choices look most compelling? I'll let you decide…

#1 AAPL Apple is by far one of the dominant stocks of our time with brand power and innovation providing a tailwind.

#2 NVDA Yes, the future of AI. You want to sell the picks and shovels to the gold miners and this is the foundational building block.

#3 AMZN Amazon has been utilizing AI for years in its store interface and fulfillment centers. Got a bump with the AI crowd, but not really a game changer for AMZN. Keep the potential for job cuts and contractionary consumer spending in mind. Not exactly a cheap stock!

#4 DHI D.R. Horton is a national home builder focusing on starter and move-up homes. Home construction has lagged demand for years. Population cohorts now wanting to buy a home confront a ridiculously low inventory of existing homes. Who wants to trade their 4% mortgage for a 7% one? New home construction will continue to see growth until such time as the economy really starts to feel pinched.

#5 PFE Last year's COVID vaccine darling, nobody likes Pfizer now since vaccine revenue has fallen off a cliff. Nevertheless, PFE has a robust pipeline of drugs in development and is using its balance sheet to pursue additive acquisitions such as the pending deal with biotechnology firm Seagen. Meanwhile there is a 4.5% dividend yield!

$6 U.S Treasury bills currently offer attractive rates of return on the order of 4.4% (roughly 2-3% in excess of long-term inflation); however, you are subject to reinvestment risk. What will the available yield be at maturity in 6-months? Moreover, the peak in the yield curve is around the 6-month maturity. Locking-in a yield for 5-years entails accepting a 100 basis point drop in yield to 4.20%, but your principal is guaranteed to be repaid by the U.S. government.

So, what is an investor to do?

1. Establish your goals/objectives.
2. Determine your ability and willingness to assume risk for the sake of return AND how much risk one needs to assume.
3. Maintain a diversified portfolio to avoid "risk of ruin".
4. Focus on whether you are on track to meet your goals or if you need to make adjustments – either in the plan, the investments or with your expectations
5. Worry less about monthly, quarterly, or even annual performance and focus on getting to your goals without losing too much sleep!

After all, that's what I'm here for!

All the best,

Jim

James W. Graves
Managing Director

[i] Source: barchart.com
[ii] Source: barchart.com
[iii] Source: Morningstar.com
[iv] https://vlab.stern.nyu.edu/volatility/VOL.SPX%3AIND-R.GARCH
[v] Source: barchart.com
[vi] All data from https://marketsmith.investors.com/mstool