A Split Market

June 30, 2023

Housekeeping: TD Ameritrade to Charles Schwab:

Before we get into the nitty gritty of the financial markets, we want to provide an update about the TD Ameritrade account conversion to Charles Schwab. To highlight something that must be proclaimed, first and foremost, CORDA is your "Go-To" relationship partner. You literally do not need to contact or liaison with Schwab or TD for any reason, at least regarding your accounts under our care. If you need something done on your account, contact us. Certainly, Schwab and TD have provided online web access, 800 numbers, or even physical branch locations to call or visit if you ever wanted to contact them directly, but we hope you have or will continue to utilize our diligent staff should you need service of any kind. For those of you who might have forgotten, Schwab effectively purchased TD Ameritrade a few years ago and we are finally at the point where they plan to turn off the TD Ameritrade website and the app-based portal over Labor Day weekend in early September. Everything TD Ameritrade-related will finally move to the Schwab umbrella at that time. Believe it or not, Schwab has been running TD for two years now, but you may not have even noticed.

So, for all of you still on the TD Ameritrade portal, Schwab is targeting Labor Day weekend for the full conversion of all accounts across the system so that by Tuesday morning, September 5th, you will be logging in to the Schwab portal and TD Ameritrade will cease to exist. You will see a stream of emails and updates from them as we approach that date, and we will keep you apprised as well. The plan will be to log in to the Schwab website on September 5th and we are extremely confident it will be business as usual. It will take some time to get comfortable with the new website, as most things internet and app-related are. But we are confident things will proceed without a hitch. We here at CORDA are already on both systems and don't have any anxiety about anything being all that different on the 5th of September or afterwards. It goes without saying, we firmly believe in the strength of Charles Schwab and all of our personal accounts will be moved to their platform as well at that time.

If you have any questions or concerns, please reach out to us! And now back to normal programming…

A Split Market:

If you are like most investors, you probably have a general idea of what the value of the Dow Jones Industrial Average is. It is the most prominent and one of the oldest equity indexes in existence. It was created in 1896 by Charles Dow, co-founder of the Wall Street Journal and Dow Jones & Company. The index is unique in that it is price weighted and tracks only thirty large companies. Today it is maintained and majority owned

by S&P Global. It has been reconstituted fifty-seven times since its inception, having last been updated in 2020 when Amgen, Honeywell, and Salesforce replaced ExxonMobil, Pfizer, and Raytheon Technologies. Although you were probably not expecting a history lesson, our point of commenting on the Dow is to remind you it probably does not mean you know how well the stock market is doing if you just follow the Dow Jones Industrial Average.

This year's stock market to date is a tale of two different narratives. One consists of a few big technology companies' share prices zooming higher off their late 2022 lows, while virtually everything else is moving mostly sideways. In 2023, the Dow (recently quoted around 33,700) is mostly flat, while the broader S&P 500 has gained about 12%. That's the widest year-to-date performance gap between the two indexes on record since 1945, according to Bespoke Investment Group. Focusing on the flattish returns of the Dow might make you feel like you are missing something, especially with the headlines dominated by the latest artificial intelligence breakthroughs and stocks tied to anything AI-related zipping higher.

For example, Cathie Wood's ARK Innovation fund, which favors futuristic stocks trading at high prices relative to earnings, is up 25%. Of course, if you review the returns of the "Magnificent 7," you will find the surging septet of big tech firms – Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia, and Tesla – have been driving the recent bull run in stocks. The unique constitution of the Dow is one thing, but if you look at the S&P 500 on an equal weighted basis, its return in 2023 is similar to the Dow, having moved up 3% thus far in '23.

Here's where things get interesting: the Dow's quirky design is to blame for its flattish performance. Its thirty stocks aren't scaled by their total value in the stock market, with bigger companies getting the greater weight as they do in the S&P 500. Instead, in the Dow, the higher share prices make up more of the Dow. For example, UnitedHealth Group, trading around $477, is the biggest stock in the Dow, constituting more than 9% of the value of the index. In the S&P 500, however, UnitedHealth's market weight puts it at approximately 1%. With UnitedHealth shares trading down 10% this year, it causes the Dow to slip. Okay, so what about Apple, it is in the Dow and is up over 30% this year, shouldn't that help? Apple's share price of $187 is well below that of UnitedHealth, so it makes up less of the Dow, weighing in at 3.5% or so. By contrast, Apple is 7.5% of the S&P 500.

Howard Silverblatt, senior index analyst at S&P Dow Jones Indices, points out that if Apple were weighted in the Dow by market value, it would make up 25% of the index! Microsoft, now 6.3% of the Dow based on share price, would be 23% of the index if it were weighted by market value.

All this is to remind you it's a market of stocks, not a stock market. Keep in mind, if you own the S&P 500 – quite possibly in your 401k plan - you indirectly own the Magnificent 7 to the tune of about 30% of that one individual holding. If ever there were a crowded trade, that's probably it right there.

Artificial Intelligence:

Take Nvidia (NVDA), it's all the rage these days as the centerpiece for everything AI. Following its recent earnings announcement, Nvidia shares were up about 30% in a single day! Nvidia must have blown out its earnings, right? Well, not really. First-quarter sales declined 13% year over year and sales of the company's highly touted gaming chips fell 38% year over year. So, what happened? Nvidia is now touting its AI chips. What we find charming is the fact that Nvidia back in 2018 was touting having the best gaming chips. Then in 2020 and 2021 they changed their tune to feature having the best chips developed for cryptocurrency miners and their machines. So here we are in 2023, and guess what, Nvidia is now the "AI" chip soothsayer. What will they be touting in 2024?

To be fair, they have clearly executed well and outflanked the competition, at least for now. We also know technology can be made obsolete very quickly, and the high margins that Nvidia is able to produce will look quite tasty to its competition. Surely, the industry won't stand on its laurels, especially in the competitive semiconductor space. That said, the question one might ask, had you bought Nvidia shares 5 years ago, would you still own it? The media and other investors fail to acknowledge that it declined by over 60% from its 2021 high to its low last September. How many investors can withstand that amount of downside volatility? It's the definition of fear and greed – investors getting shaken out last year, and those now are getting sucked right into the FOMO trap, Fear of Missing Out. Be careful out there, investing is not easy!

Lo and behold, Nvidia is arguably the most overvalued stock in the S&P right now. Prior to the move up, Morningstar had the shares rated as 1-star with a fair value of $200 (when the shares were in the mid-200 range, mind you). In terms of market cap, that means fair value was just under $500B. The shares are now currently north of $1T. The market cap of NVDA is now 7x larger than Intel (INTC), while NVDA sales are less than half of INTC ($27B vs $63B in 2022). The shares are now trading at ~150x earnings and ~40x sales. It makes little sense. Valuation still matters.

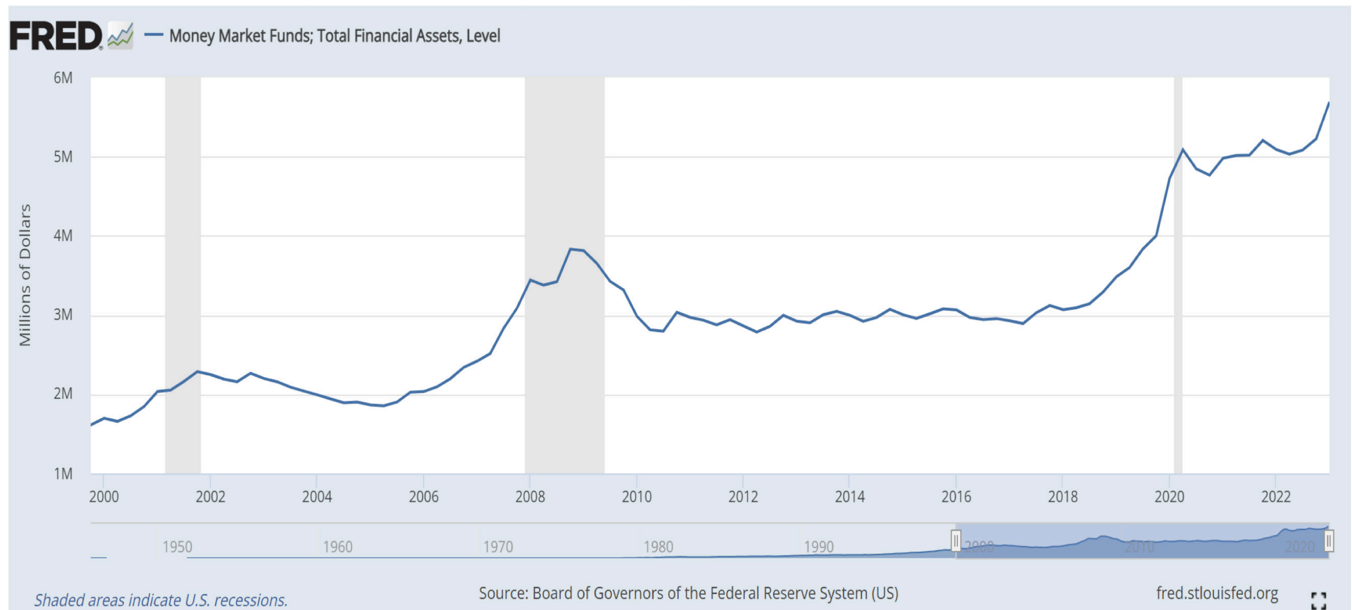
Why? Let's take a road trip back to the year 2000. Many of you are familiar with Cisco Systems. Founded by two Stanford University professors back in 1984 its name derived from the city of San Francisco. This may have been the dotcom bubble granddaddy of them all. CSCO traded at 200x earnings in the year 2000. Cisco was and is a quality business. What is startling, in the ensuing 22 years since then, Cisco has grown their revenues by 400% and their profits by 500%. Guess what, the shares have yet to return to the price level they reached in 2000. Could Nvidia do the same?

If you firmly believe AI is going to have a significant impact on the economy, you can be assured the capable managers running the businesses in your portfolio are actively engaged and allocating capital to machine learning and other AI-related projects. It just doesn't get the attention from the media like more famous brands such as Tesla, Alphabet, and Microsoft. One side note, AI is not something that came about in 2023. For example, Alphabet's "Other Bets" division has been investing in AI for many years. Alphabet acquired Deep Mind, their research unit that specializes in AI, for over $500mm in 2014. But take the pharmaceutical industry, for instance, Merck, Pfizer, Sanofi, Johnson & Johnson, and others can use the unparalleled data processing potential of AI systems to accelerate and reduce the cost of discovering new drugs. In the consumer staple industry, firms such as Nestle, Pepsi, and Unilever are leveraging AI, machine learning, data science, and predictive analysis across their business units whether to create new products and services or to augment their sales efforts. For example, their marketing campaigns are enhanced with AI when engaging thousands of marketers, and even more agency partners, spanning hundreds of countries to deliver effective campaigns across a host of platforms, especially digital versus television. Bottom line, AI is prevalent and represented in your portfolio at exceptional valuations. We want to own a great business at a good price and are judicious about the price we are willing to pay.

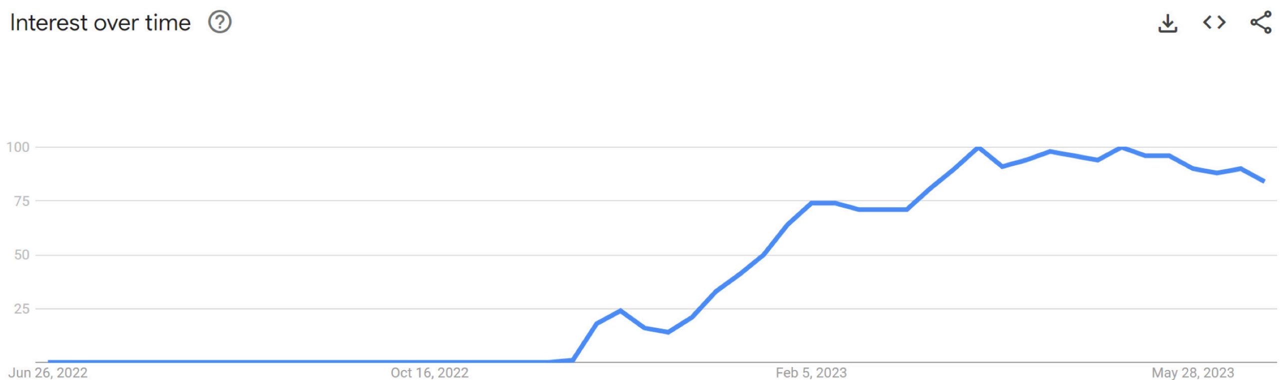
Macro Backdrop:

As for the macro backdrop here in June 2023, there is good news and bad news as we head into the back half of the year. First, the bad news. The economy continues to provide mixed signals. It seems to be softening and the long-touted recession could still be on the horizon. The Federal Reserve is signaling a couple more rate hikes ahead and really no plans to cut interest rates anytime soon. That said, the good news is that inflation is rolling over and the economy is not crashing as unemployment remains near historical lows. There's always a level of dysfunction in Washington D.C. and the constant drumbeat of geopolitical risks, but the reality is that there are always countless risks. The stock market over the long term has weathered many different storms and there's no reason to think this time is different.

With so many investors piling into money market funds, short term Treasuries, and certificates of deposits, we once again find ourselves building that proverbial "wall of worry." It's interesting to note that this massive cash hoard could be the ballast that drives share price appreciation in future years. See below the graph from the St. Louis Federal Reserve depicting total assets held in money market funds, coming in at $5.7T as of March 31, 2023. Note how during past recessions how much money market funds climbed higher.



Be wary of bubbles. This is a Google Trends graph of the search word "ChatGPT." Virtually non-existent last year but exploding here in 2023. Hype has a knack for fueling bubbles.



William Bernstein's masterpiece, *The Four Pillars of Investing*, highlights four conditions for a bubble to develop. The first is a major technological revolution, think about the impact of electricity, steam engine, automobile, internet, etc. The second condition is easy access to credit. If money is available, then fewer barriers exist for people to not just put their money behind an idea, but for someone else's too.

The third condition is that people must have already forgotten about the last bubble. We could argue it's been over 20 years since the internet bubble, but we should also be mindful of the meme stock craze two years ago or the surge in cryptocurrencies and alt coins where again, there was a significant amount of investor FOMO. So, the first two conditions are clearly present, maybe not the third, but then as Bernstein wrote, the fourth condition is a "complete abandonment from time-honored methods of security valuation." As bubbles grow, investors lose the ability to value assets on traditional metrics, so they need to justify new ones. Speculators buy simply because prices keep rising. Have you heard of this before?!

It's hard to say if AI is in a bubble yet, but we could be moving in that direction. We'd argue steering clear of it until better understanding how it will evolve. There were hundreds of automobile companies in the early part of the 20th century, how many are still standing today? There were many companies created in the late 1990's as the internet grew and it was going to change the world, but how many went bankrupt? Thousands. It took a decade for companies to figure out how to profit from it. AI is moving fast, but it is hard to predict the outcome. We have confidence in the managers running the businesses we own to deploy AI and machine learning wisely, just be careful about how you might interpret all the noise about AI should you be looking to invest.

Viewpoint:

Our view is to be extremely patient and thoughtful about what assets to own. Most CORDA clients own a few of the Magnificent 7 that have powered higher in the first six months of 2023, but we also favor a diversified portfolio of high-quality dividend paying businesses. If they trade sideways but their operational results are intact, we will not lose sleep. It will just be a matter of time before share prices reflect their intrinsic value. If these businesses continue to provide top and bottom-line growth and a future stream of steadily increasing dividends over the next decade, we will garner a solid and substantially smooth rate of return. We won't get caught up in FOMO, as our focus is unabashedly the return OF your principal as much as a return ON your principal. As Warren Buffett sometimes reminds us, Rule #1 is *Do not Lose Money* and Rule #2 is to not forget Rule #1.

In closing, as we write from Houston, we anticipate a long sweltering summer ahead. We've been hitting 100 degrees consistently of late, so we are hunkered down to sweat out the next few months of a typical summer here in Texas. You can be assured we have a whole team "sweating out" the details of a bifurcated market and watching things closely across all asset classes so you can go enjoy summer vacations and family time with loved ones. So, enjoy, take care, and best wishes from all of us at CORDA.

The CORDA Team.