Holt Capital
Partners, L.P.

Second Quarter Financial Market Commentary

"Ninety Days in Ninety Seconds"

June 30, 2024

The Death of Diversification?

- The cover story of the August 13, 1979, issue of *Business Week* famously declared "The Death of Equities." It took another three years for inflation and interest rates to peak and stocks to bottom, but the subsequent returns have obviously defied the headline.
- The quote that "diversification is the only free lunch" in investing is widely attributed to Nobel Prize winning economist, Harry Markowitz. Diversifying across asset classes and securities has withstood the test of time and provided investors with reduced risk and enhanced returns. The question for today's investors is whether the Magnificent Seven (Alphabet, Amazon, Apple, Meta Platforms, Microsoft, NVIDIA, and Tesla), and more recently the Terrific Two (NVIDIA and Meta), have killed the benefits of diversification.
- Although the Magnificent Seven dominated performance in 2023, only NVIDIA and Meta have been significant positive outliers thus far in 2024. Those two stocks were responsible for over 35% of the return of the S&P 500 in the first half of the year. Narrow stock market leadership, led by highly valued technology stocks, brings back memories of the dot.com boom and bust of twenty-five years ago.
- The legislation that governs mutual funds was passed in 1940. Those rules were designed to enhance diversification and reduce concentration risk but have recently hindered returns for a wide range of sector-based index funds and exchange-traded funds (ETFs). To maintain compliance with rules that limit individual stock concentrations, these regulations have forced many mutual funds to be sellers of their mega-cap tech winners. This has limited the ability of many funds to accurately track their underlying indexes.
- While artificial intelligence is in many ways a game changing megatrend, investor enthusiasm will inevitably exceed company fundamentals and in the future these mega-cap tech stocks will exhibit more normal patterns of volatility, both up and down. The benefits of diversification will also reemerge, and a broader range of high-quality companies will once again become market leaders. Diversification may be taking a siesta, but it is not dead!

Fed Policy - The slow Path to Lower Rates

- The financial media is fixated on *when* the Federal Reserve will begin cutting rates. This is a misguided focus. Economic growth has recently slowed from a very high level but remains robust. While inflation has not reached the Fed's 2.0% target, it appears reasonably contained. The key point is that policy rates have almost certainly peaked, so the cyclical direction is down. A long time horizon is an investor's friend, not the short-term emphasis on trying to predict the actions of the Federal Reserve.

Fed Policy - The slow Path to Lower Rates (continued)

- There is much debate about whether Fed policy is too restrictive or whether it remains too loose. Tight credit spreads, strong profit growth, and rising stock prices are indicative of monetary policy that is not restrictive. A prudently executed monetary policy will produce the best results for the financial markets and the economy in the long run. Our view is that policy makers are likely to err on the side of conservatism in their battle against inflation. We believe that short term rates are likely to slowly fall over time and that should be positive for businesses, consumers, and investors.

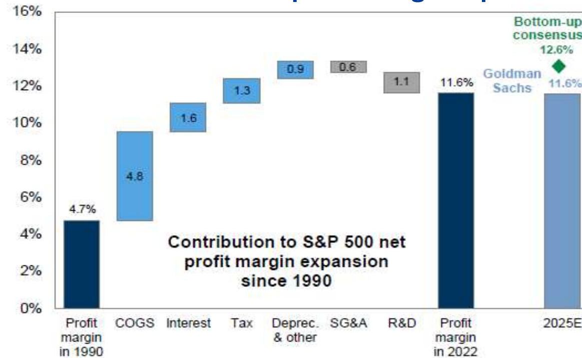
Two Economies

- Most economic data depict a strong economy. Financial markets also broadly reflect strength. The confusing political fact is that this strength is not represented in President Biden's polling data. Most surveys of likely voters do not rate Biden favorably on economic policy issues and Trump typically scores higher on his handling of the economy.
- Why is there such a disconnect? Americans increasingly live in a bifurcated economy. Individuals in the top three quartiles by income generally own their home outright or have a mortgage that was refinanced when rates were much lower. Businesses also benefited from locking in low interest rates for extended periods. Inflation is less impactful for this cohort. The bottom quartile of consumers experience inflation almost daily in the cost of food and other necessities. They see rents rising and are more exposed to higher interest rates on outstanding credit balances. A strong job market is a positive, but for many workers, wage growth has not been strong enough for them to feel like they are getting their piece of the American Dream.

Do Today's Valuations Reflect Higher Quality Businesses?

- Valuations are historically high in today's stock market. That raises questions about overvaluation and downside price risk. What is important is evaluating the value investors receive for the prices being paid. All else being equal, a more profitable company is a more valuable company.
- Most profitability measures, including profit margins and return on equity (ROE), have risen over the past several decades. The same is true of shareholder-friendly capital allocation policies. Net profit margins for the S&P 500 have more than doubled since 1990. This change has been driven primarily by lower costs and lower interest expense. Likewise, ROE for the S&P 500 has risen from 14% to 21% over the past three decades. Accompanying these higher levels of profitability has been a more disciplined approach to the use of cash by large companies. Dividends and share buybacks have risen from about 27% of cash flow in 1990 to an estimated 43% in 2024.

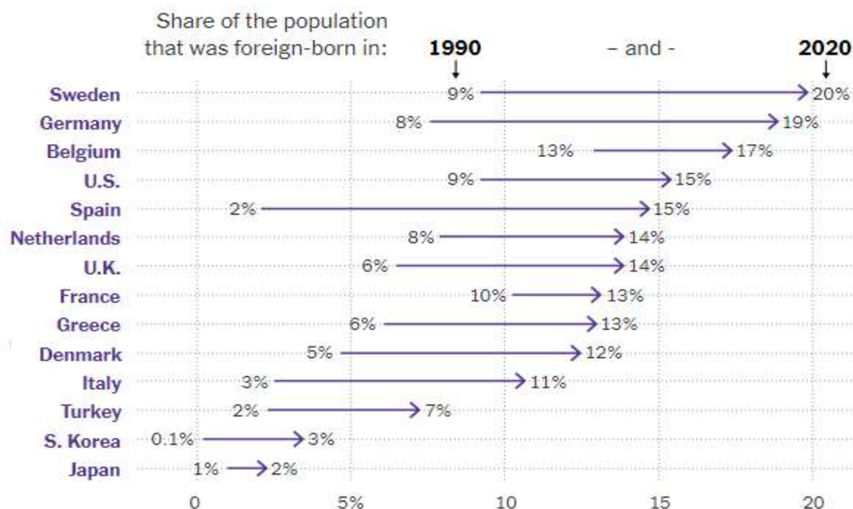
DO TODAY'S VALUATIONS REFLECT HIGHER QUALITY BUSINESSES? (CONTINUED)



- Today's companies are more profitable, with more disciplined capital return policies than was the case a generation ago. Higher quality businesses merit higher valuations. Maintaining these fundamental attributes are key to sustaining current valuation levels.

INTERNATIONAL OBSERVATIONS

- It is easy to think of immigration as a domestic issue with a range of political ramifications. However, the *New York Times* recently reported that virtually every Western country has experienced a sharp increase in the share of their foreign-born population. The cultural ramifications are one of the most hotly debated topics of our time. From a strictly economic perspective, this trend has likely had the positive impact of holding down costs and consumer prices in labor-intensive industries.



Election Musings

- The upcoming presidential election in the U.S. has dominated headlines, but more than thirty national elections will be held across the globe in 2024. India, Mexico, and France have recently had elections with outcomes that surprised the pundits. Elections that result in shifting political ideologies often impact financial markets in the short run. However, a recent *Financial Times* study showed that political labels are not a meaningful long-term factor. Rather it is simply the transition of power to new leadership and the accompanying hope for a better future that is most highly correlated with better economic growth and stronger financial market returns.

Conclusion

- The economy remains healthy, and earnings estimates reflect robust growth in 2024 and 2025. Inflation and interest rates are likely to be lower a year from now, which should benefit credit-sensitive sectors of the economy. Valuations are reasonable based on 2024 earnings estimates and future earnings growth should provide further valuation support.

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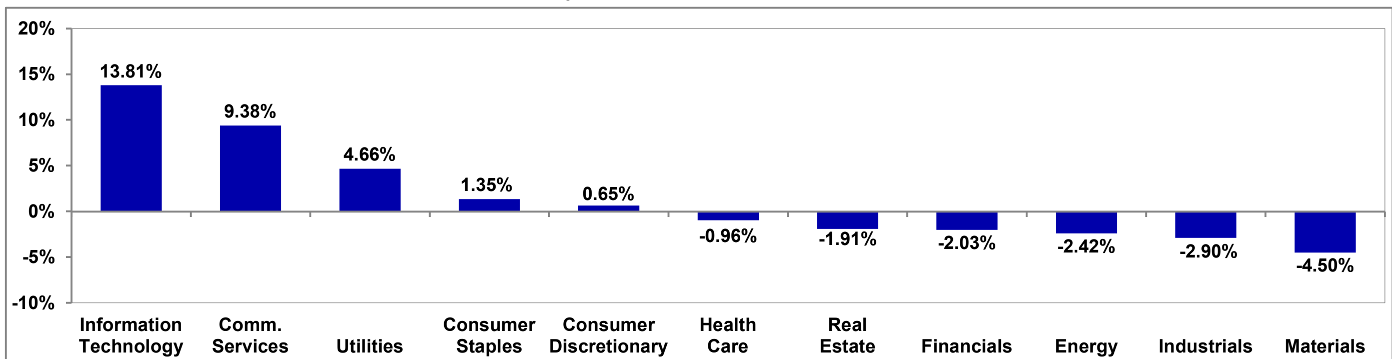
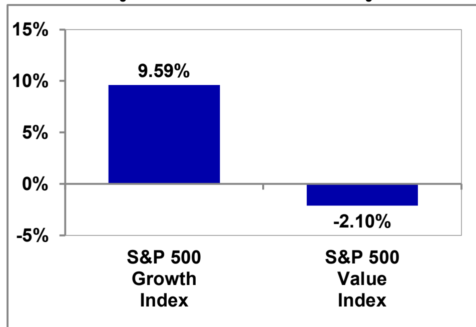
Second Quarter Investment Performance (including income)

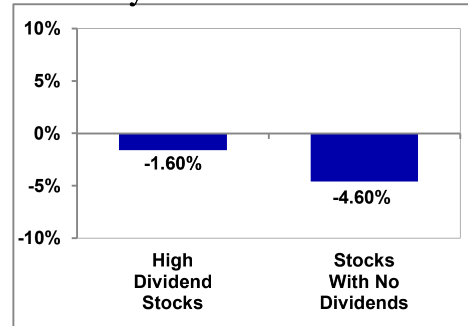
By Economic Sector



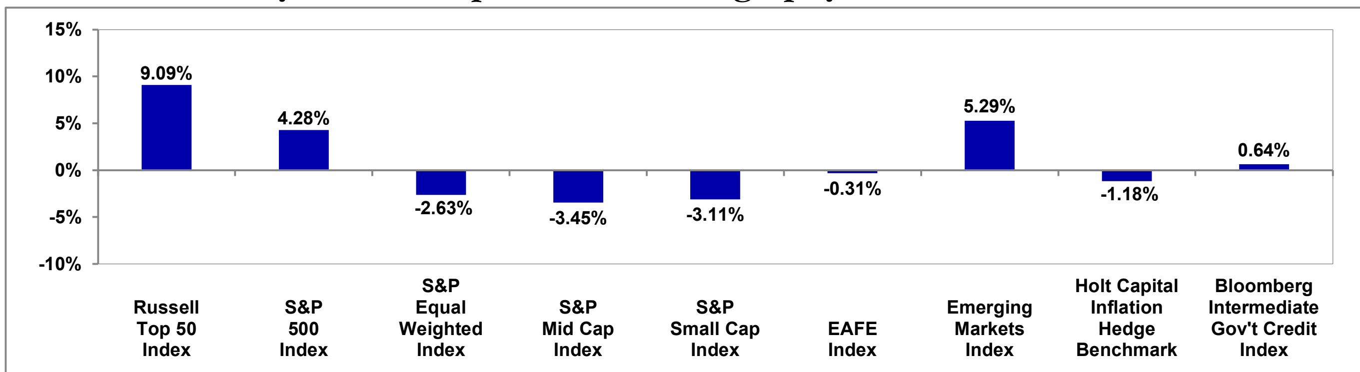
By Investment Style



By Dividend Yield



By Market Capitalization, Geography and Asset Class



- Sometimes the broader stock market can be accurately represented by the return of the S&P 500. The second quarter was not one of those periods. Focusing solely on the S&P500 would ignore the negative returns of the average stock in the index, as represented by the equal weighted index. Likewise, value, mid cap, small cap, and developed market foreign stocks all declined.

- Does history provide any lessons for markets that have very narrow leadership? Interestingly, the last time that the NASDAQ Index, which is dominated by tech stocks, outperformed the S&P 500 by such a wide margin it was the peak of the dot com bubble. The opposite is true for small cap stocks, whose underperformance versus large companies is the worst since 2001. These data points suggest that there is historical precedent for these performance differentials to converge.

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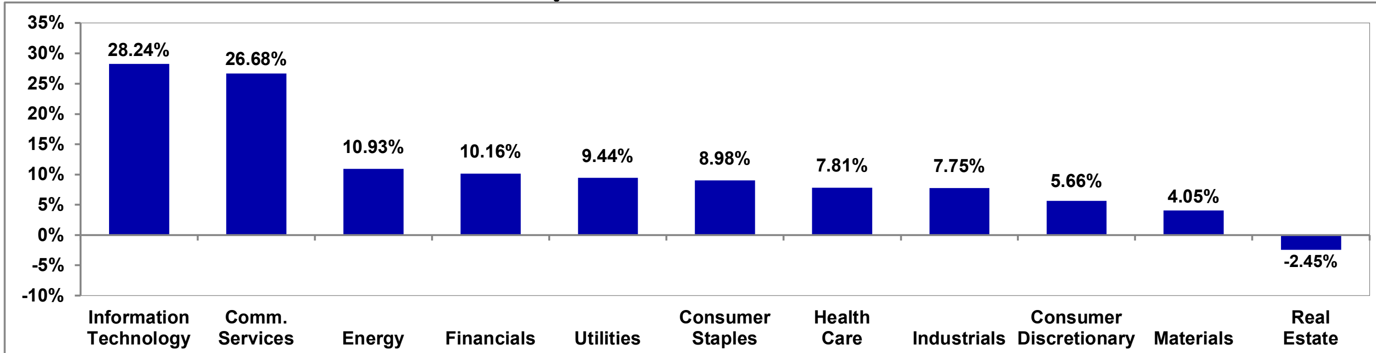
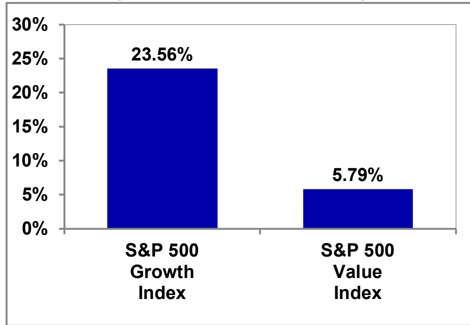
Year-to-Date Investment Performance (including income)

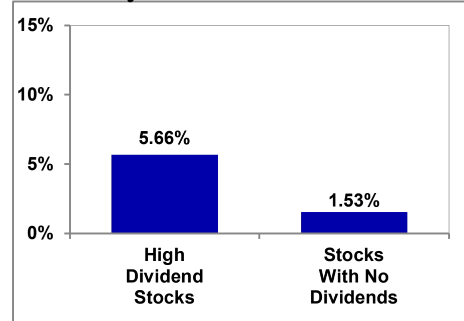
By Economic Sector



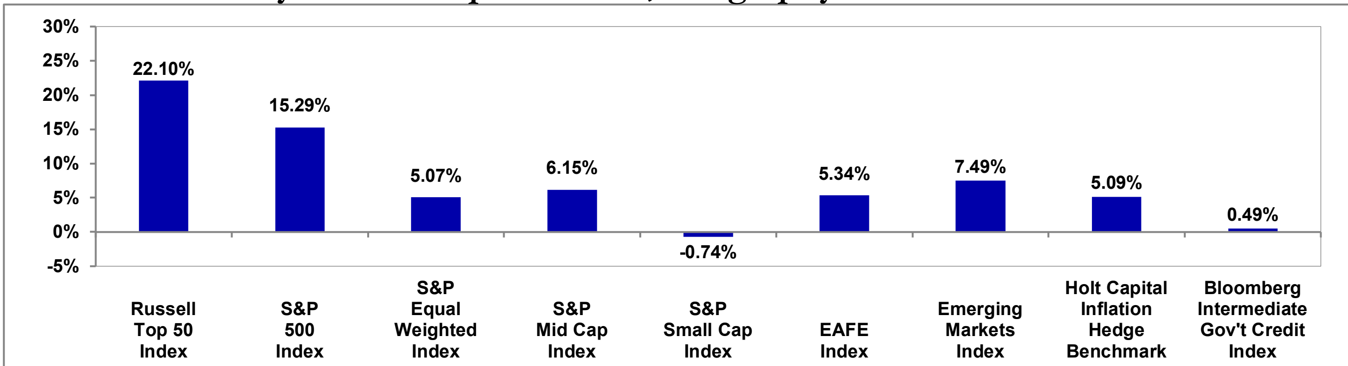
By Investment Style



By Dividend Yield



By Market Capitalization, Geography and Asset Class



- The performance impact of highly valued mega-cap technology stocks is evident in the graphs above. The difference between the 15.29% return of the market cap weighted S&P 500 and the 5.07% return of the average stock in the index was the widest since at least 1990.
- The narrowness of the market is also evident at the sector level. Nine out of eleven economic sectors underperformed the S&P 500 Index. The tech-heavy S&P 500 Growth Index outperformed its value counterpart by over fourfold.
- International markets posted mid single digit returns, while intermediate maturity bonds generated a return that was only modestly positive.