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INVESTMENT MANAGEMENT

SLIMMON'S TAKE > TAKEAWAYS & KEY EXPECTATIONS

Equity Market Commentary

APPLIED EQUITY ADVISORS TEAM | SLIMMON'S TAKE **|** JUNE 2024

AUTHOR

ANDREW SLIMMON

Managing Director and Senior Portfolio Manager, Applied Equity Advisors

The following views and perspectives are formed by the work of the Applied Equity Advisors team in managing assets for investors.

1. Please join us next month on ***Wednesday, July 17th*** at ***4:15pm ET*** for *Applied Equity's Q2 Portfolio Review and Market Outlook*.

2. "Slimmon's TAKE" and other forms of communication between quarterly reviews are opportunities for us to update investors on our positioning or thoughts on the current market environment. Frequency of communication tends to be correlated to the present volatility in the market.

   Year-to-date, the market has performed much as we had anticipated, and our strategies have delivered on both an absolute and relative basis. Lately, for that reason, your inbox has received less from us.

   We simply think it is more important for us to be highly visible in the tough times than in the good times.

   However, do not misconstrue fewer emails with complacency on our part! A permanent sense of "*what dangers are lurking*" is part of our daily dialogue even when the portfolios are performing well.

3. One of the best performing factors year-to-date is *earnings revisions*.[1] Simply put, the better the earnings revisions, the better the stock's performance. Likewise, the worse the revisions, the worse the stock has performed.

   Given stock prices are the present value of future earnings, better-than-expected company fundamentals should be rewarded by investors. Likewise, the reverse holds true.

   In our opinion, the current environment is symptomatic of an equity market acting *extraordinarily rationally.*

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[1] Bloomberg. Current year earnings per share, three-month change.

The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.**

4. Currently, it is difficult to find a company with better earnings revisions than Nvidia. Over the past year, research analysts revised their FY24 earnings estimate for Nvidia by 170%.[2] Clearly, Wall Street has dramatically underestimated the current earnings power of this company and, as a result, the stock has soared.

   As much as Nvidia has captured most of the media attention, it is not the *only* company with excellent earnings revisions. Other companies simply do not get the coverage Nvidia does.

   As Nvidia stock price has levitated relative to the rest of the market, so has its single stock risk. And let us not forget, *Nvidia has had **ten** 50% stock price declines since going public in 1999*.[3]

   But with other companies also performing fundamentally well, there are plenty of opportunities to offset this single stock risk. We would highlight the Infrastructure Act and the Chips Act beneficiaries as very straightforward themes. A second opportunity would be the current developments in the wealth management industry. For a third, in our opinion, weight loss/diabetes drugs are still in the early stages of broad acceptance.

5. Back on February 22nd, I was interviewed by Barry Ritholtz on Bloomberg's *Masters in Business* podcast. The interview was a primer on how Applied Equity Advisors invests. Thanks to all of you who listened, he asked me back for two short *At the Money* snippets, "Avoid Closet Indexing" (April 17th) and "Building A Concentrated Portfolio" (May 8th).

   Here are three key high-level comments from the two podcasts:

   1) I have no problem with indexing. What I intensely dislike is "closet indexing" active management. If a fund owns many stocks, its unlikely to differ enough from its index to outperform after fees. As legendary investor Bill Miller once said:

      > *The shift from active to passive has not been properly framed. It is simply switching from expensive passive investing to inexpensive passive investing*.[4]

      For this reason, I am not at all surprised that so much money has moved to passive ETFs.

   2) Keep in mind, as much as a sizable portion of active managers have struggled to outperform the index, *100% of pure passive strategies underperform after fees*. Especially if an advisory fee is tacked on. Negative alpha is pretty much guaranteed.

   3) Statistically, high active share[5] managers, on average, outperform over the long-term, net of fees.[6] However, high active share comes with a wider dispersion of return to the index than closet indexing. This can cause great happiness at times and consternation at others. When investors get on the

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[2] Bloomberg, June 11th, 2024
[3] Bloomberg.
[4] Bloomberg, October 2016
[5] Active share is the percentage of the portfolio or fund that is invested differently than its benchmark as of the last day of the reporting period.
[6] Antti Petajisto, "Active Share and Mutual Fund Performance," January 15, 2013. Study of performance of 1,124 U.S. long-only equity mutual funds from January 1990 – December 2009, net of fees and transaction costs.

scales and evaluate returns on a very regular basis, the dispersion of returns can cause poor investment timing decisions.

Unfortunately, therefore, the higher the active share, the more likely investors are to pull money at the exact wrong time.[7] (I can see the flows from both the advisory and self-directed routes. It's such an argument for investors to use professional advice!)

In effect, I believe high active share strategies, on average, can add alpha to passive portfolio allocations that have locked in underperformance. However, to be effective, the period for evaluation for high active share strategies cannot be short-term.

Andrew

[7]Morningstar Research Services, LLC, "Why Fund Returns are Lower Than you Might Think", Amy Arnott, CFA, August 30, 2021, and ING, adapted from Petajisto (2011): "How Active is Your Fund Manager? Active Share and Mutual Fund Performance;" Martijn Cremers, Professor of Finance, University of Notre Dame.

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