MANAGED ASSET PORTFOLIOS

MAP THOUGHT PIECE

MARKET CYCLES: MUCH LIKE A PARTY, INVESTORS TEND TO REMEMBER THE GOOD TIMES BUT FORGET THE HANGOVER

MAP'S MARKET PERSPECTIVES | AUGUST 2023

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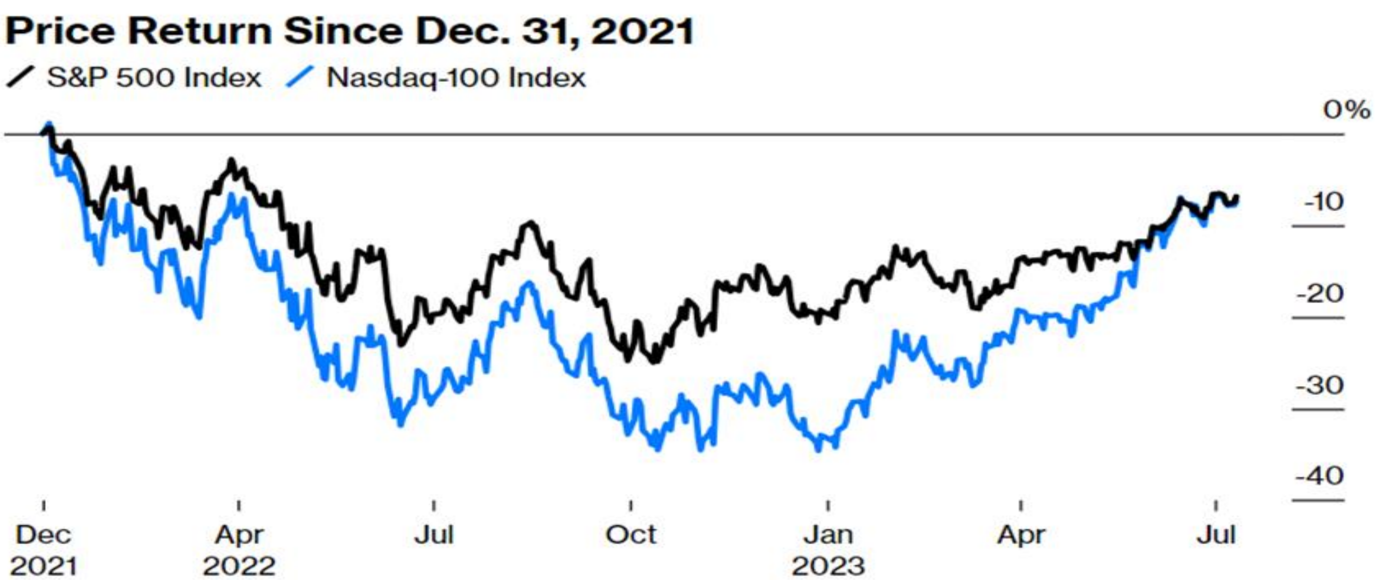
Life is not linear; you have ups and downs. It's how you deal with the troughs that defines you. Much like life, performance measurement is a process, not an event. It's a flowchart, not a checkbox. As a long-term value manager, we have specific processes in place geared towards generating attractive risk-adjusted returns. We don't avoid trends. Rather, our Investment Team seeks long-term, *structural* investment theses, or themes, designed to address the trends we believe are durable based on specific macroeconomic forecasts. One of the key themes identified by the Investment Team is that innovation and technology will be a critical differentiator between companies – both positive and negative. Those companies that adopt innovation and technology effectively across their operations should ultimately be winners; whereas those that fail adoption or have their businesses disrupted by innovation and technology could wind up the losers over time.

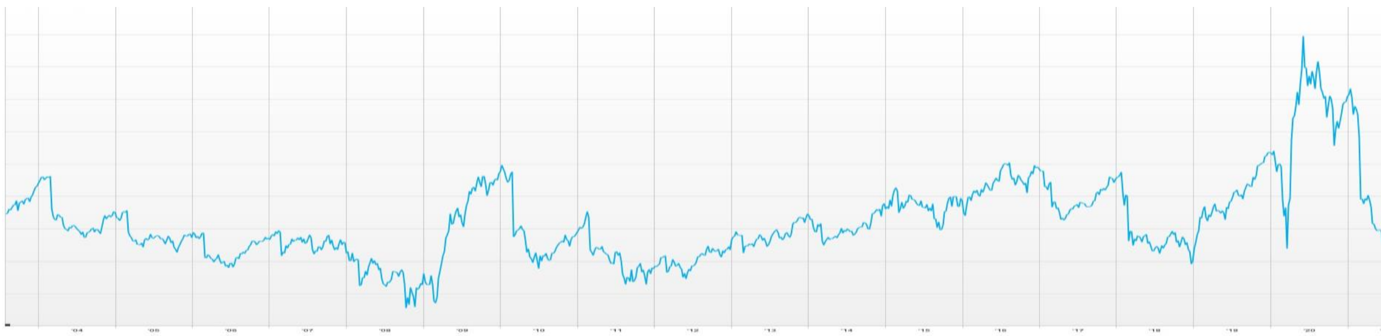
In the most recent issue of MAP Views, the Investment Team highlighted the outsized impact of the Magnificent Seven[1] on the returns of the broader indices for the first half of 2023. The largest contributor to the returns of the Magnificent Seven was investors' enthusiasm around the opportunity for Artificial Intelligence (AI). While we believe AI has an abundance of potential, not only for those in the technology sector but others as well (i.e., retail, health care, industrials, etc.), we consider the current AI investing environment reminiscent of previous periods of market history that warranted caution from investors. Before we embark on a history lesson, let's discuss the short-term memories investors sometimes develop during periods of euphoria.



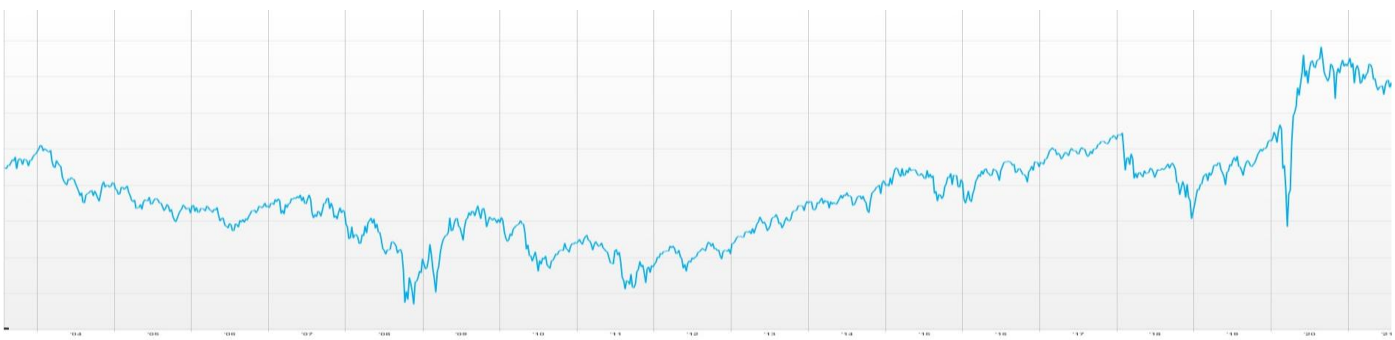
Source: Bloomberg 07/13/2023

Even though the Magnificent Seven drove the bulk of the advances of the S&P 500 (up 16.89%) and NASDAQ-100 (up nearly 40% - its best first half of the year performance) during the first half of 2023, those same companies were down significantly in 2022 as many were expecting the Federal Reserve (the Fed) would drive the economy into a recession as they attempted to fight the inflation battle with the fastest pace of interest rate hikes in history. More specifically, the Nasdaq-100 and S&P 500 declined 33% and 19%, respectively, in 2022. In other words, as depicted in the chart above, if you held technology stocks through the past 18 months, you had a volatile ride but ended up worse off than you were in December 2021. It is worth noting that Managed Asset Portfolios' (MAP's) Global Equity composites have fared much better during this period. They were down approximately 4% on a net basis, and outperformed their MSCI ACWI benchmark, which lost 6.26% during the same period.

S&P 500 Forward P/E - NTM



S&P 500 PEG – FY1



Source: FactSet

Markets reached peak valuations as measured by the PEG ratio, which compares a company's price-to-earnings (P/E) ratio to its expected rate of growth, in 2021, leaving them exposed to the sharp drawdowns mentioned above when market dynamics changed. With the rise of the Magnificent Seven, valuations have become elevated as seen in the chart above, nearing levels achieved in 2021 and above their historical averages. This implies that either growth needs to reach a level larger than is currently expected or interest rates need to decline. Both scenarios are heavily exposed to the economic environment and cause us to tread carefully. It also draws sharp comparisons to the dot-com era.

Party Like It's 1999: The dot-com Bubble Headache

Speculative markets are characterized by exuberance and the belief in unlimited growth potential. The dot-com bubble exemplified this behavior, as investors poured money into internet companies without thoroughly assessing their long-term viability or profitability. The Internet created a lot of opportunities for investors, but inflated expectations and lofty valuations also led to the bursting of the dot-com bubble. Nothing exemplifies this more than Pets.com, the American online pet food retailer founded during the dot-com era. The pet food and supplies company is perhaps the most recognized flop from the dot-com bubble because of its famous marketing campaign. Pets.com ran ads featuring a dog sock puppet interviewing people on the street. The mascot appeared in a Super Bowl commercial and even got its own balloon in the Macy's Thanksgiving Day parade in 1999. When Pets.com went public in February 2000, its stock IPO'd at $11 a share and rose to a high of $14.

However, Pets.com's business model wasn't sustainable. The company lost $147 million in the first nine months of 2000, and the company was unable to secure additional cash from investors. As such, the rally was short-lived and Pets.com's stock quickly fell below $1 and stayed there until its demise. The company folded in November 2000, and laid off about 300 employees.[2]

Indeed, many of the key players in the AI space today have better business models than companies embroiled in the dot-com mania. However, technology valuations as measured by the PEG ratio are near levels experienced prior to the bursting of the dot-com bubble as seen in the chart below. Technology companies have a forward P/E ratio of 28.1, and the seven biggest companies have an average forward P/E ratio of about 36.[3] This compares to the forward P/E ratio of the S&P 500 of 19.8. We are by no means predicting the AI movement is bound for as quick of a decline as experienced during the bursting of the technology bubble. Rather, we believe that relative valuations of these names have become stretched and that other sectors and companies with more attractive valuations may offer better risk/reward opportunities, highlighting the importance of diversification.

S&P 500 Information Technology Sector Forward P/E - NTM

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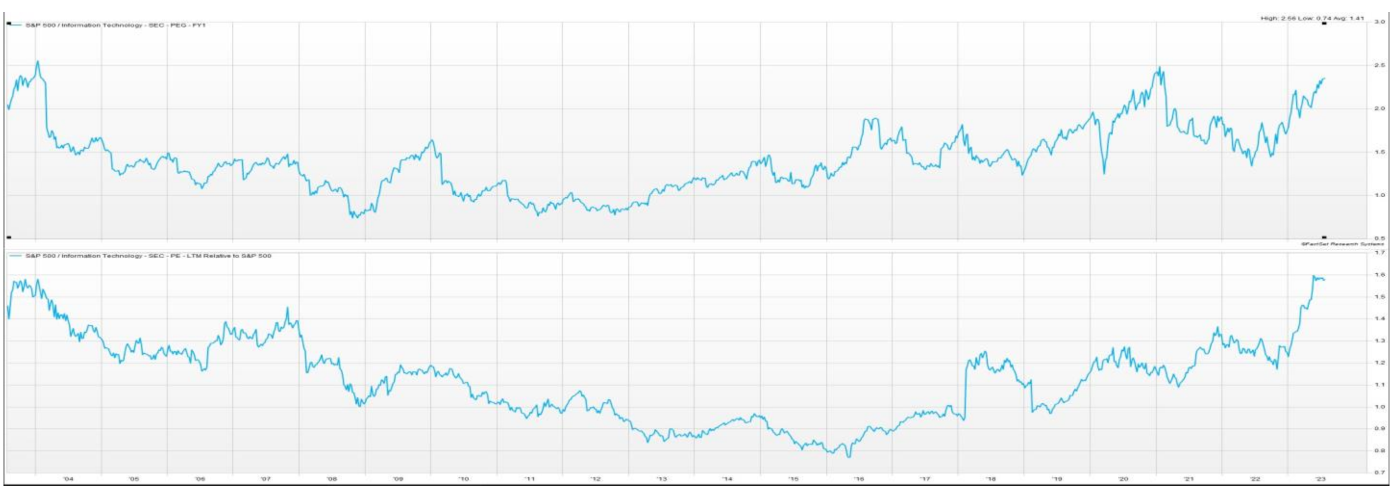

Source: FactSet

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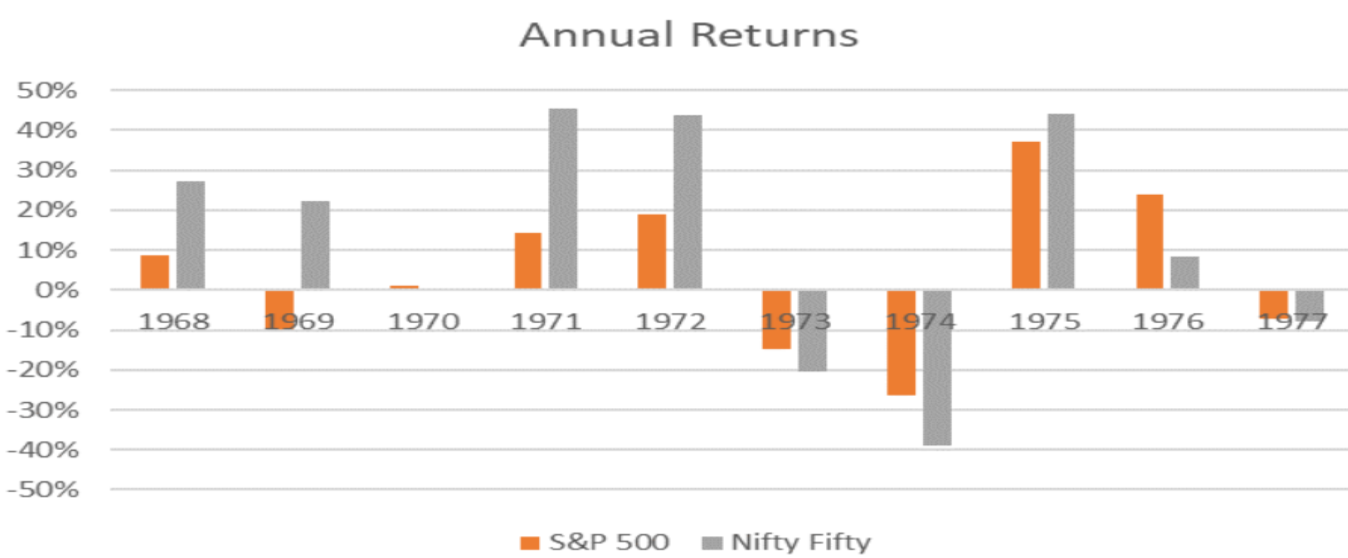
Party Like It's 1972: Lessons From The Nifty 50

In the late 1960s and early 1970s, the Nifty Fifty were stock market darlings comprised of a set of roughly 50 large growth companies. Unlike the dot-com bubble, investing in these firms was not considered speculative. Instead, the Nifty Fifty were typically quite successful companies, with strong earnings growth and profitability. But a great company is not necessarily a great stock, and starting in 1973, their returns disappointed for years. The ten largest stocks by market cap at the end of 1972 were IBM, Eastman Kodak, General Electric, Sears Roebuck, Xerox, 3M, Procter & Gamble, Coca-Cola, Avon Products, and Johnson & Johnson. If you had held on to many of these names, as an investor, your returns would be quite disappointing, with the exception of a few.

For the five years through 1972, the Nifty Fifty had averaged over 22% annual earnings growth, with over 30% growth in 1972. For the S&P 500, these numbers were just 4% and almost 13%, respectively. These companies were profitable as well, with a return on equity (ROE) of over 22% on average, well above the historical ROE of 14% for the S&P 500. With financial results like these, investors flocked to these stocks, and at first, they were not disappointed. For the five years through 1972 average annual returns were almost 28%, with an average return of over 43% in 1972. In comparison, over the same five years, the S&P 500 averaged about 6.7%, with a return of just under 19% in 1972.[4] However, similar to the trends mentioned above, these stocks became quite expensive, with an average P/E of about 43 at the end of 1972. This was well more than double the P/E ratio of the S&P 500.[4] The recession of 1973 – 1975 ushered in a period of low economic growth, and with it a bear market. As can be seen in the chart below, the Nifty Fifty stocks fell over 19% and 38%, in 1973 and 1974, respectively, before rebounding in 1975 and 1976, only to decline again in 1977, underperforming the broader index.



Source: Refinitiv, S&P Global Ratings, CRSP, Compustat, Bridgeway calculations

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Summary

As we have penned in the past, history has a reputation of repetition. Lessons learned from historic market events can provide investment professionals with a map to aid them in navigating through these periods. The tides and storms may differ, but those that stay the course have the potential to make it safely to port. Of course, investors would love to be able to time the market perfectly, investing at market bottoms and moving to cash at peaks. Unfortunately, such market timing is challenging for all investors, no matter how sophisticated. Rather, in our opinion, it is about the time in the market, not timing the market, which allows investors to best position themselves for strong long-term results.

As mentioned at the onset of this piece, we believe achieving attractive, long-term risk-adjusted returns starts with a specific, thoughtful investment process. At MAP, we adhere to a strict, repeatable, proprietary investment process combining bottom-up fundamental analysis with a thematic macro-overlay. Additionally, our focus on catalysts helps us to target stocks prior to inflection points. This process has resulted in portfolios that have generated strong risk-adjusted returns on an absolute and relative basis over multiple rolling time frames.

Please do not hesitate to contact your MAP representative with any questions.

Managed Asset Portfolios Investment Team

Michael Dzialo, Karen Culver, Peter Swan, John Dalton, and Zachary Fellows

August 2023

[1] Amazon, Apple, Alphabet (GOOG/GOOGL), Meta, Microsoft, NVIDIA, and Tesla – making up 28% of the total value of the S&P 500, up from 20% at the start of the year.
[2] https://money.cnn.com/galleries/2010/technology/1003/gallery.dot_com_busts/
[3] https://www.bloomberg.com/news/articles/2023-07-13/top-tech-stocks-power-an-18-month-surge-from-bear-to-bull-market
[4] https://bridgeway.com/perspectives/party-like-its-1972-what-can-the-nifty-fifty-teach-us-about-todays-market/

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