ADKINS SEALE CAPITAL MANAGEMENT, LLC
Investment Commentary
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Dear Clients:
An even casual consumer of financial/business news programs would have noticed the near incessant coverage of all things dealing with “artificial intelligence” as if the concept was all new. Our society has benefited from things artificial for decades if not centuries, depending on how one defines “artificial.” Think generated electricity versus lightning, pacemakers to normalize heart beats, bionic knee and hip replacements, and all manner of chemical compounds to cure a host of human and animal diseases. Alternatively, we can think of a few artificial influences that may not be so beneficial. Think pop up ads on the internet, incessant cell phone usage, fantasy activities, and almost anything virtual reality.

From an investment perspective, the hottest current item in the artificial intelligence space deals with the out-sized earnings growth potential for common stocks of the technology bellwethers – Apple, Microsoft, Alphabet (formerly Google), Meta Platforms (formerly Facebook), and Amazon. For 2023, the total investment returns for these common stocks ranged from a low of 49% to a high of 194%, primarily from the benefit of rising price to earnings multiples. Average annual total returns for these stocks have exceeded those of the broad market indices for the last 3, 5, and 10 year periods, despite significant under-performance in 2022.

Perhaps the most dramatic example of AI driven expectation for rapid earnings growth was demonstrated by the common stock of NVIDIA. This stock realized a total investment return of 239% for 2023 and has a ten year average annual return of 62%. The market capitalization of the stock is now around $1.2 trillion, with net income of $18.9 billion for the most recent twelve months. To rationalize that trailing twelve month price to earnings ratio of 65x (an earnings yield of 1.5%), we did a high level “back of the envelope” simulation of future earnings needed to support the current price. By our calculations, the current price can be justified by 35% annual earnings growth for the next five years and a terminal value in year six of $2.1 trillion. Our estimate of terminal value assumes annual earnings growth of 6% beginning in year six and a required forward return of 10%; these terminal value assumptions are considered reasonable for a mature, US large cap stock. While there are a near infinite number of future earnings and return combination assumptions, we think this approach highlights the potentially excessive optimism in the current price for NVIDIA’s stock. NVIDIA made its mark through the development of graphics processing units for gaming applications. To say there a number of high quality, well capitalized competitors in this marketplace would be an understatement. Time will tell whether NVIDIA can deliver sufficient future earnings to justify the current price.

The other hot AI example is in the weight loss, diabetes management pharmacology sector. The common stocks of Eli Lilly and Novo Nordisk have generated annual total returns in excess of the broad market indices for most of the last ten years, including having positive returns for the down year of 2022. Currently, the common stock of Eli Lilly trades at a trailing price to earnings ratio of 105x (earnings yield of 0.95%). While it possible that future earnings will support the current quote, the pharmacology sector has many capable and well-funded companies that compete with these two operators.

Time will tell if the current market hype for new advances works out as hoped. We have seen examples of excessive optimism in stock prices before and generally found such instances to precede material price declines. Yogi Berra’s “deja vue all over again” quote comes to mind. In addition, we are struck by the reality that most of the current hype in technology artificial intelligence deals with software applications written by humans and thus subject to the market forces of competition and creative deduction. The late great Charlie Munger perhaps said it best – “I am skeptical of some of the hype that has gone into artificial intelligence. I think old fashioned intelligence works pretty well.”

Market Returns as of December 31, 2023

Investment returns for the full year marked a significant turnaround from results in 2022. The total return on the S&P 500 Index was 26.3%, while the returns on smaller-capitalization US stocks averaged 16+%. The broad indices for non-US stocks returned about 15.6% in US dollar terms, reflecting a slight benefit from a falling US dollar exchange rate. Stock prices both in the US and abroad were set up for modest gains through September as rising bond yields pushed capital costs higher. Beginning in mid-October, market expectations began to price in an end to the US Federal Reserve Bank's higher interest rate program to lower consumer price inflation. For the fourth quarter of 2023 alone, the total return on US and non-US stocks were nearly 12% and 10%, respectively, driven almost exclusively by rising earnings multiples.

Returns on broad investment grade fixed income securities (bonds) showed sharp reversals in the fourth quarter. The return on the Bloomberg US Aggregate Bond Index was 6.8% for the quarter, more than offsetting a negative -1.2% return through September. Likewise, the Bloomberg Global Majors exUS Bond Index generated a total return of 9.9% for the quarter compared to a negative -6.1% return for the first nine months of the year. Bond yields at year end 2023 were very similar to the year end 2022 levels across the globe; the yield on the Bloomberg US Aggregate Bond Index was around 4.5%, compared to a 2.4% yield on the non-US bond index.

Our View Going Forward

Stock and bond markets both experienced significant price volatility in 2023 as shifting perceptions about the future course of economic activity and interest rates impacted estimates for valuation factors. We applaud the existence of positive real returns on bonds and believe this condition is a necessary foundation for setting reasonable valuations on all investment assets. Currently, the pricing for US Treasury bonds suggests a forward nominal yield of about 4% and an implied annual inflation rate of about 2%. Absent a material economic recession, such bond yields would be consistent with equity market annual returns of between eight and ten percent. The major risk for near term equity market returns arises from the impact of significant reductions of future earnings annual growth rates for the technology and pharmacology companies cited above. Historically, price declines in current market leaders "bleeds" over to a majority of the index components. We would see such a revaluation event as being a positive development for longer term returns but may involve significant declines in the market values of securities. The other major risk to both stock and bond markets would be a resurgence in annualized inflation; this event would raise the capital cost for all securities, effectively lowering market values. Our clients should see their portfolios remain with an under-weight of long duration exposure over the near term. Continued evidence of sustained real interest yields combined with more normalized earnings multiples for common stocks should pave the way for higher weightings to longer duration assets.

In Closing

We look forward to visiting with each of you about your investment results and expectations for the future and to make sure your portfolios are aligned with your specific circumstances. We greatly appreciate the opportunity to serve as your investment adviser and pledge our best efforts to meet your expectations.

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