ADKINS SEALE CAPITAL MANAGEMENT, LLC
Investment Commentary
July 5, 2023

Dear Clients:
Warren Buffett credits his mentor, Benjamin Graham, with imprinting his investment decision making process with this principle – "Price is what you pay. Value is what you get." As we survey the investment landscape of the last few years, we observe numerous instances of material divergence between price and value. Due in large part to overly loose monetary policy since 2009, investment asset prices have generally equaled or exceeded "expected" value calculated using a historically reasonable return requirement. Investment asset prices for certain large capitalization companies have become inflated through "irrational exuberance" – think the "Nifty Fifty" stocks of the early 1970's, the "Dot.Com" fantasy of the late 1990's, the housing bubble of 2005-07, the COVID-induced "Meme" stampede of 2020-21, and most recently the "Artificial Intelligence" (AI) rapture. History shows sharply lower stock prices following the first four of these episodes, so let us take a deeper look at the current condition of US stock prices in relation to values.

The total return on the S&P 500 Index for the year to date and trailing twelve months as of June 30, 2023 was 16.9% and 19.6%, respectively, with the twelve month return being nearly double the long term average for annual returns. Even more striking than the overall average return is the fact that essentially all of the above average return was generated by eight stocks – Alphabet (Google), Amazon.com, Apple, Meta Platforms (Facebook), Microsoft, Netflix, NVIDIA, and Tesla. The aggregate market value of these eight stocks was about 28% of the total market value of all 500 stocks in the Index. Using data provided by Morningstar, Inc., we estimate the capitalization weighted year to date and trailing twelve month total return of these "elite" eight stocks to be around 71% and 41%, respectively. Our estimate of the capitalization weighted total return for the other 492 stocks combined for a negative 3% year to date and about 11% for the trailing twelve month period. For the year to date period, price weakness for large capitalization stocks in the utility, energy, health care, financial, and consumer staples sectors contributed to the unfavorable return outcome.

The out-sized returns for the elite eight were generated almost exclusively from price appreciation rather than earnings/dividend realization. For example, the current price for NVIDIA, a truly AI darling stock with a 3% weighting in the S&P 500 Index, had investors paying $220 for each $1 of reported earnings or a 220x price to earnings ratio. Even its forward price to earnings ratio was high at 56x. The favorable price action for NVIDIA resulted in a near tripling of its stock price year to date and for the last twelve months. For pricing multiples at this level to reflect reasonable value, the company's future earnings and sustained growth must be significantly above that of the overall index constituents. We find such expectations truly artificial and ripe for recalibration from a dose of earnings reality.

In contrast, giving all 500 stocks the same weight (equal weight method) results in year to date and trailing twelve month returns of about 7.0% and 13.7%, respectively. This suggests average returns for the elite eight of 84% and 67%, respectively, for the two periods. A reasonable estimate of the aggregate returns from the other 492 stocks for the same periods is 5.7% and 12.6%, respectively. Since each stock using this approach has an equal 0.20% weighting, the smoothing of returns of 500 stocks results in a return pattern closely resembling longer term averages.
Unlike the bubbly price attributes of the elite eight, the pricing factors for the other 492 stocks look more sustainable. We estimate the current trailing twelve month and forward price to earnings ratio for this group to be around 17x and 15x, respectively, which is on par with the long term average for the overall index and consistent with an expectation of annualized forward equity returns of 10%+/-. Our near term concern for all stocks in the broad index is the historical tendency for major price draw-downs for a meaningful subset of the index to pull most of the entire cohort in the same direction. In addition to this tendency, the upward repricing of bond yields and negative sloping short to long yield curve point to a slowdown in the economy and resulting decline in forward earnings together raise the odds of a material contraction in stock prices. Artificial intelligence may turn out to be less smart than hoped, so "Caveat Emptor" (buyer beware).

Turning to interest rates, we find the long awaited return to yield normalcy in full motion with two significant caveats. First and foremost, we do not believe the bond market is fully convicted on the outlook for future consumer price inflation. The current yield curve for securities issued by the US Treasury from one year at 5.4% to ten years at 3.9% implies stable forward one year returns of around 3.7%. Historically, the one year yield for US Treasury securities has tracked annualized inflation closely. In contrast, the one to ten year yield curve for US Treasury Inflation Protected securities (TIPS) suggest a CPI of 2.3%. Second, a normalized yield curve should be constructed with an expected inflation rate plus yield premiums for maturity extension (duration) risk. The long term average duration premium is about 2%, which suggests a ten year UST bond yield of between 4.5% and 5.7% with both levels above the current quote. Yields on corporate bond issues would also have to reflect a premium for credit risk. This factor may provide additional upward pressure on interest yields and resultant increase in the equity risk premium for stocks. We find all the talk about the next interest rate move by the Federal Reserve Bank to be mostly noise. We suggest actions which maintain a positive real return above inflation to be a welcome and necessary condition, while the idea of lowering yields below the inflation rate as a cure for economic contraction is the financial equivalent of "snake oil."

Market Returns as of June 30, 2023

The total return on the CRSP Total US stock market index for year to date and trailing twelve months was 16.2% and 18.9%, respectively, as smaller capitalization stocks under-performed the S&P 500 Index. The total return on the MSCI-ACWI ex-USA stock index for the same time periods was 9.5% and 12.7%, respectively. Non-US stock market returns did not benefit from the "tidal lift" of artificial intelligence rapture. For most of our clients, US and non-US equity holdings are constructed with an index hub to capture momentum moves and active spokes that employ an emphasis on paying prices below a security's intrinsic value, aka with a "margin of safety." This approach has benefited portfolio returns during major draw downs (January 2022 to mid-October, 2022), but generated lower relative returns during periods experiencing manic price surges such as from mid-October 2022 to June 30, 2023. The benefit of this approach to managing the "price versus value" risk is neither always successful nor are all successes obvious; but we maintain a conviction that your interest will be best served through this process.

The total return on the Bloomberg US Aggregate Bond Index for year to date and trailing twelve months was 2.1% and -0.9%, respectively. This index is comprised on all outstanding US investment grade taxable fixed rate bonds. The average yield on such bonds was 2.3% for the recent six month period or about 4.6% annualized. In short, bond yields are rapidly approaching a level that provides the potential for a real, after-inflation return. This is a good outcome for achieving favorable risk-adjusted portfolio returns.

Our View Going Forward

The highly speculative behavior of the stocks highlighted above drives us to remain cautious about the broad stock market indices and to maintain meaningful weights to stocks with solid earnings and balance sheets priced at lower earnings multiples. Allocations to index holdings will rise as index multiples decline, while allocations to active strategies will rise as index multiples move higher. We expect to maintain a tilt to higher quality fixed income but to begin extending bond durations to core intermediate positions in light of the rise in interest rates. Bond yields are beginning to offer reasonable compensation for the risk from duration extension.

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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