June 2024

“While enthusiasm may be necessary for great accomplishments elsewhere, on Wall Street it almost invariably leads to disaster” - Benjamin Graham

From last Weekend's WSJ:

AI Frenzy Gives Stocks Monster First Half

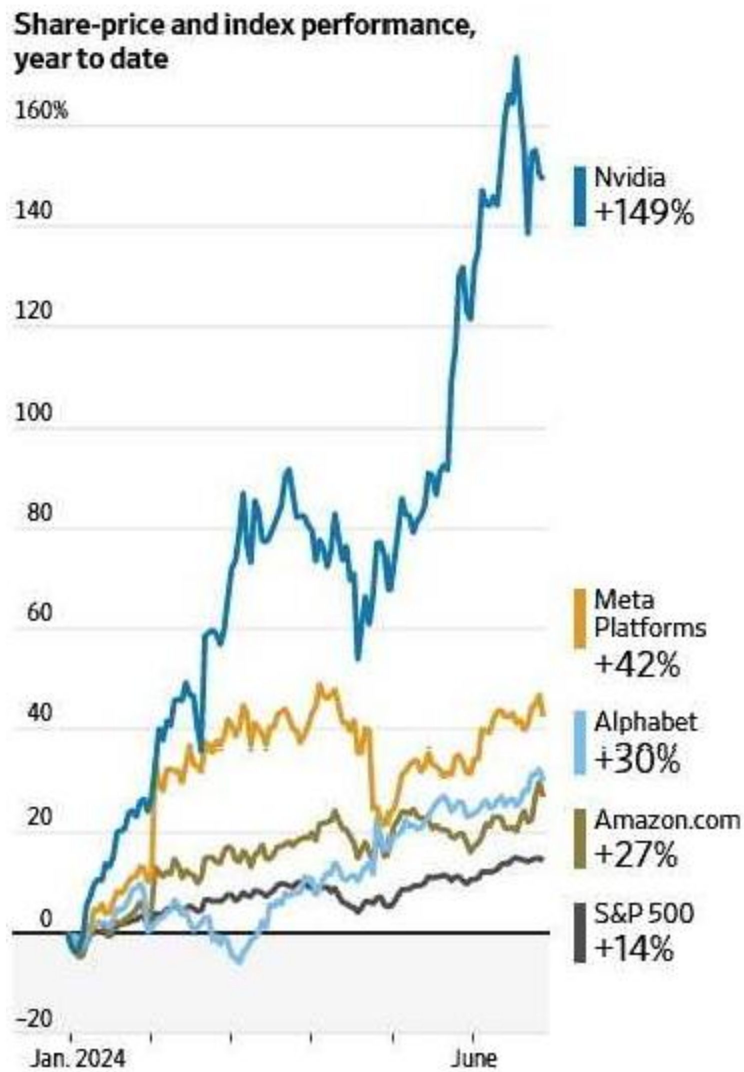
S&P 500 has climbed 14% despite reduced hopes for interest-rate cuts

BY KAREN LANGLEY

The AI fervor powering the stock market shows no sign of cooling down.

Much as in 2023, investors piled into bets in the first half of this year that the artificial intelligence boom is just getting started. They sent **Nvidia** shares soaring 149%, propelling the graphics-chip maker’s market value above $3 trillion and briefly making it the most valuable company in the world.

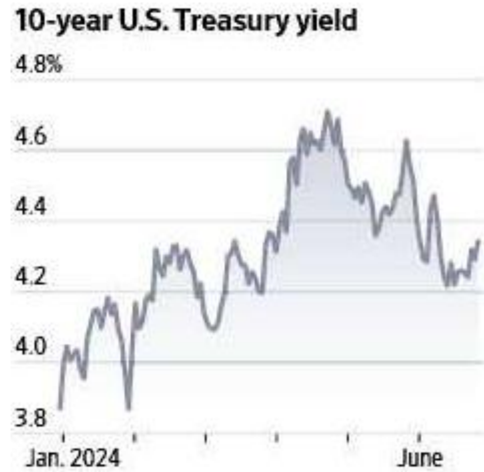
Nvidia’s ascent is a big reason the S&P 500 has climbed 14% this year—nearly as much as in last year’s standout first half—even as a series of hot inflation readings damped investors’ hopes that the Federal Reserve would soon begin to cut interest rates.



Investors entered the year thinking the central bank might lower rates some halfdozen times, giving them a cheery view of the path ahead for stocks. But data in the following months showed price pressures were persisting, and the Fed has held off on rate cuts so far.

That shift helped push bond yields higher, with the yield on the benchmark 10-year U.S. Treasury note climbing to 4.342% on Friday from 3.860% at the end of last year. Rising yields tend to weigh on investors’ enthusiasm for taking on the risk inherent in the stock market. But in the first half of 2024, eagerness to own a piece of an AI-charged future won out, pushing the S&P 500 to 31 record closes.

Entering the second half, many investors are feeling --good. Corporate profits have been strong, and signs of easing inflation have bolstered hopes that the Fed will cut rates this year. Still, there are reasons the rally could stall. Markets could lose patience if the central bank continues to leave rates unchanged. The election season pitting President Biden against former President Donald Trump could spark volatility, with traders racing to discount the shifting likelihood of policy changes. Elevated valuations could make stocks susceptible to disappointments of any kind.



So far, Nvidia has contributed 30% of the S&P 500's total return, including dividends, this year through Wednesday, according to S& P Dow Jones Indices. Throw in Google parent Alphabet, Microsoft, Facebook parent Meta Platforms and Amazon.com, and you have accounted for well over half of the broad U.S. stock index's return. ...

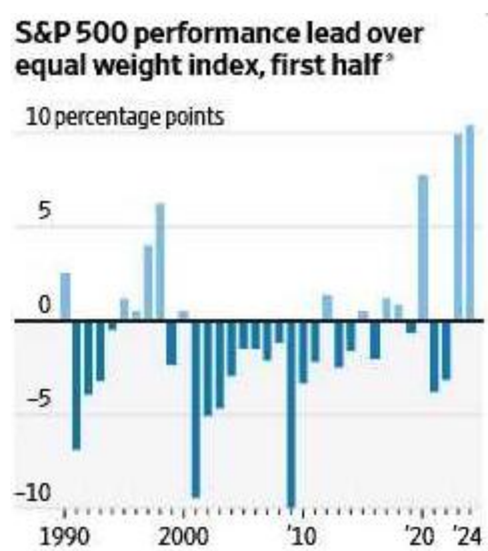
Nvidia's surge has prompted some on Wall Street to draw comparisons with the tech bubble, while many investors point to the company's blowout profits as evidence the stock's moves are justified.

Still, signs of potential froth worry some onlookers. May brought a reappearance of the meme-stock trade, which in 2021 transfixed Wall Street and Main Street alike. Shares of GameStop rallied after a social- media account associated with Keith Gill, known as "Roaring Kitty" on YouTube and "DeepF—ingValue" on Reddit, posted a picture of a man leaning forward in his seat.

Bitcoin hit records after regulatory approval of a wave of retail-oriented funds energized cryptocurrency believers. Investors have dashed into junk bonds, suggesting little concern that an economic slowdown will lead to a rise in defaults and bankruptcies.

While artificial intelligence might ultimately affect companies throughout the economy, the recent trade has been more limited. In one indication of the extent to which big tech stocks have been powering the market, an equal-weighted version of the S& P 500 is lagging behind the benchmark index, in which large companies hold more sway than smaller ones, by the most in decades.

The equal-weighted index is up just 4.1% so far this year, underperforming the S& P 500 by 10 percentage points—the biggest gap in the first half of a year in data going back to 1990, according to Dow Jones Market Data. ...



A rally that is dependent on a handful of stocks makes some investors nervous. Nvidia, whose stock can be subject to big moves, fell 13% over three trading sessions earlier this month, a potential warning sign for investors. ...

Analysts expect profits from companies in the S& P 500 to grow 11% this year, with every sector except energy and materials showing an increase, according to FactSet. Next year, they anticipate earnings will rise 14%, with the help of all 11 S&P 500 segments.

Another reason for caution: Stocks don't look cheap. The S& P 500 traded this week at about 21 times its projected earnings over the next 12 months, near its priciest since January 2022, according to FactSet. The 10-year average is about 18 times. ...

From Global Investment Strategy on June 26:

Third Quarter 2024 Strategy Outlook: Here Comes The Pain

I. Macroeconomic Outlook

... In 2021, when most analysts were expecting the Fed to stay on hold for years to come, our framework predicted that inflation would suddenly surge. This motivated us to go short the 10-year Treasury note in June of that year when it was yielding just 1.45%.

In 2022, when most analysts were saying that a recession was imminent, our framework predicted that one would be avoided.

In 2023, when most analysts were insisting that bringing inflation back to target would entail significant economic pain, our framework predicted an "immaculate disinflation." This kept us bullish on stocks.

And now, in 2024, when most analysts are expecting a soft landing, the very same framework is predicting that a recession will start suddenly and unexpectedly later this year or in early 2025.

... When unemployment is high, firms can hire workers without having to raise wages. However, once full employment is achieved, the only way that firms can expand their payrolls is by poaching workers from other firms. This can lead to a leap-frogging cycle of ever-higher wages and prices. Such a cycle can only be stopped by curbing aggregate demand, usually through tighter monetary policy.

There have been only two times in post-war US history where aggregate labor demand exceeded supply by a meaningful amount: The second half of the 1960s and during the pandemic. Both episodes saw an explosive rise in inflation. ...

Fast forward to today, the official job openings rate has fallen from a peak of 7.4% in March 2022 to 4.8% in April. Timelier high-frequency data from Indeed and LinkUp suggest that openings fell further in May and June. The job openings rate is now probably only a whisker above 4.5%.

As Fed Governor Waller has noted, a drop in the openings rate below that level has historically coincided with rising unemployment.

Two years ago, workers who lost their jobs could simply walk across the street to find new work. That has become increasingly difficult, as evidenced by the recent increase in the number of people who are unemployed due to job loss (as opposed to more benign reasons that can lead to rising unemployment, such as when formerly discouraged workers enter the labor force).

The ongoing softening in labor demand can be seen in a myriad of other indicators, including the hiring rate, quits rate, posted wages, and business surveys.

... The Great Recession began in December 2007. In the fourth quarter of that year, real GDP expanded by 2.5%. Over the course of 2006 and 2007, home prices declined while pockets of stress surfaced in some corners of the financial system such as subprime mortgage lending. As 2008 wore on, the weakening economy put further strain on banks. Ailing banks cut back on lending, leading to an even weaker economy, and ever higher nonperforming loans. A vicious cycle erupted, culminating in the Global Financial Crisis.

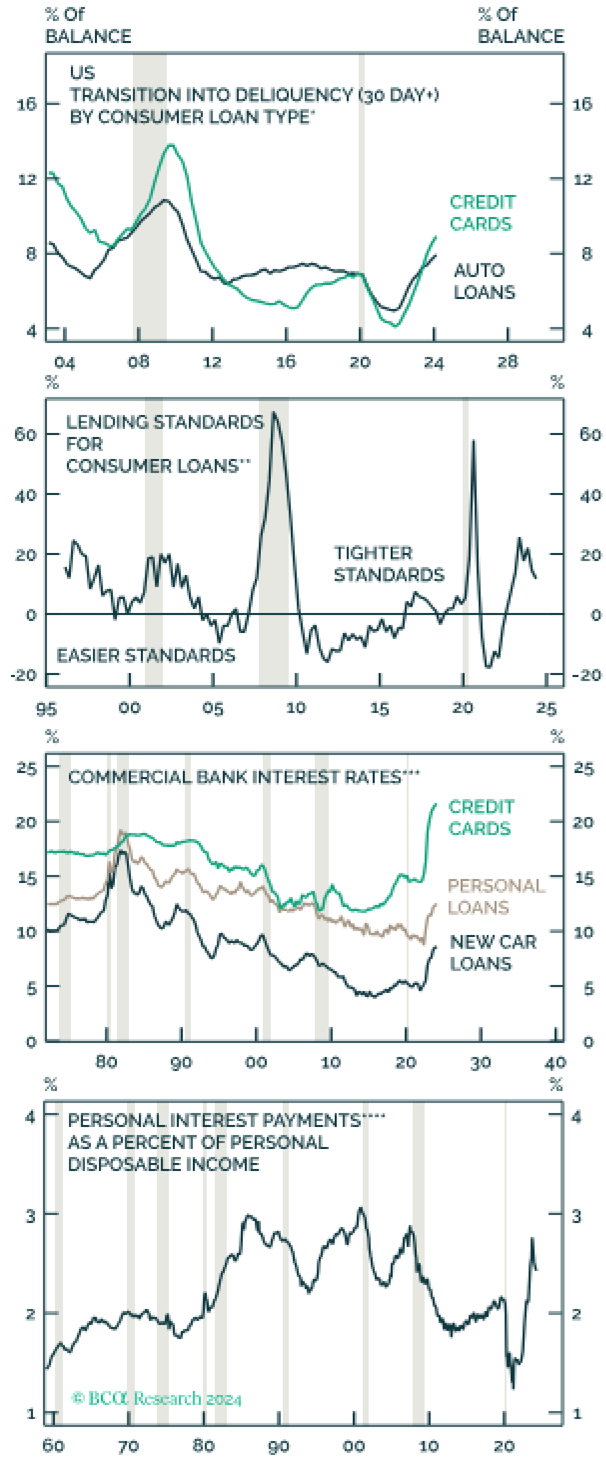
We do not expect anything as dramatic this time around. Nevertheless, a variety of feedback loops are likely to emerge later this year that will cause the economy to weaken significantly

Rising unemployment will prompt consumers to raise precautionary savings. The personal savings rate stood at 3.6% in April – half of what it was in 2019. Unlike in 2022, US households no longer hold significant excess savings (**Chart 8**). Excluding money market funds, which are generally held by the rich, bank deposits have returned to pre-pandemic levels. Amongst the poorest households, real bank balances are well below where they were in 2019.

The ability of households to borrow against future income receipts will also become challenging (**Chart 11**). Credit card and auto loan delinquency rates are already back to where they were in 2010, a year in which the unemployment rate averaged

CHART 11

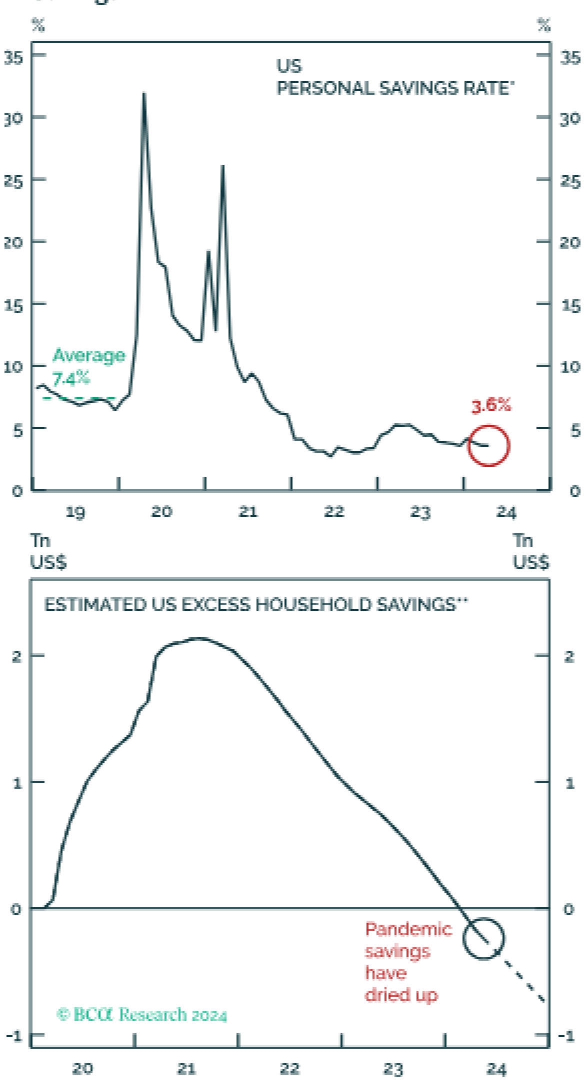
Negative Outlook For Consumer Loan Growth



* SHOWN AS A 4-QUARTER MOVING TOTAL. SOURCE: FEDERAL RESERVE BANK OF NEW YORK.
** SOURCE: FEDERAL RESERVE, SENIOR LOAN OFFICER OPINION SURVEY.
*** SOURCE: FEDERAL RESERVE.
**** SHOWN AS A 12-MONTH MOVING AVERAGE. SOURCE: BUREAU OF ECONOMIC ANALYSIS (BEA).
NOTE: SHADED AREAS DENOTE NBER-DESIGNATED RECESSIONS.

CHART 8

US Households Will Need To Spend Less Now That They Have Run Out Of Excess Savings



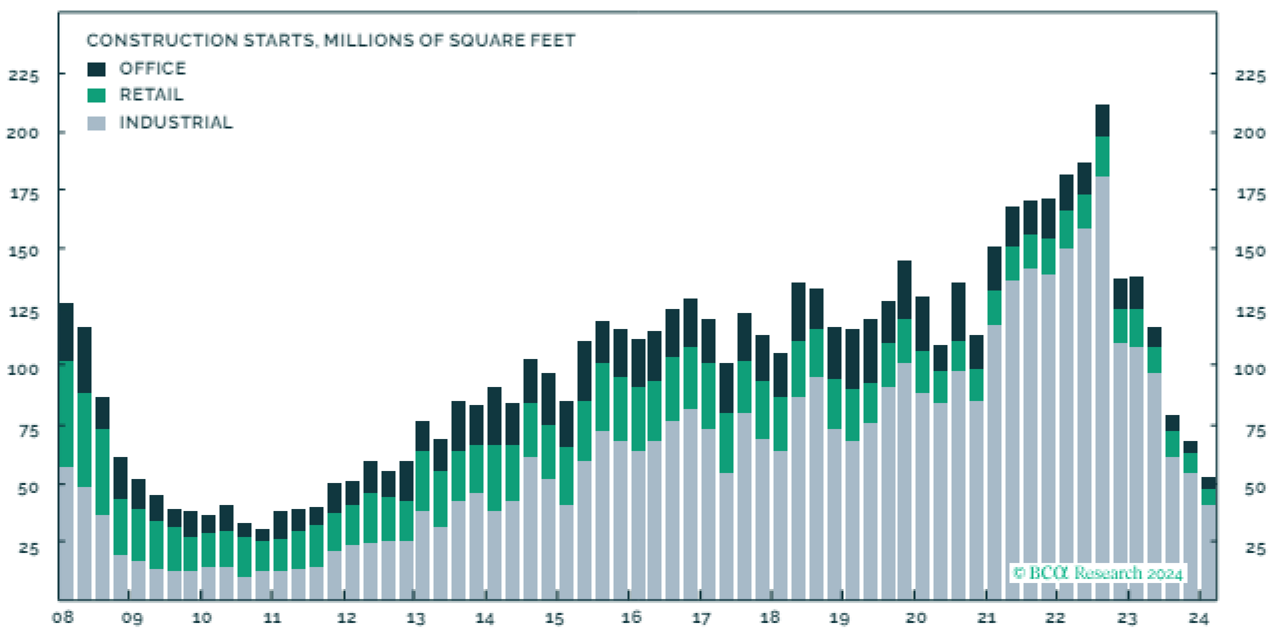
* SHOWN AS A PERCENT OF DISPOSABLE INCOME.
** SOURCE: "DATA REVISIONS AND PANDEMIC-ERA EXCESS SAVINGS", H. ABDELRAHMAN AND L. OLIVEIRA, FEDERAL RESERVE BANK OF SAN FRANCISCO, NOVEMBER 8, 2023.

9.6%. Banks have tightened lending standards and jacked up interest rates on consumer loans.

With little accumulated savings to draw on and credit availability becoming more constrained, many households will have little choice but to curb spending. Decreased spending will lead to less hiring. Rising unemployment will curb income growth, leading to less spending and even higher unemployment.

A similar dynamic will afflict business investment. Despite a soaring stock market and continued enthusiasm over reshoring, AI Investment, the CHIPS Act, and so on, our capex intentions tracker remains depressed. Commercial construction starts are at a 12-year low (**Chart 13**). Weakening consumer demand will cause businesses to further scale back expansion plans.

CHART 13
Commercial Construction Starts Have Plummeted



SOURCE: COSTAR.

The Fed Won't Stop The Coming Recession

Will Fed rate cuts prevent a recession?

We do not think so. First, in the absence of overwhelming evidence that the economy is at imminent risk of a recession, fear of a second wave of inflation will make the Fed reluctant to cut rates aggressively.

... the level of consumer prices is now slightly above where it would have been if inflation had averaged 2% since the Global Financial Crisis. The Fed was lucky that inflation was consistently below target going into the pandemic. At this point, however, allowing another overshoot could unanchor longterm inflation expectations.

Second, it is probable that effective monetary policy will continue to tighten even after the Fed starts cutting rates. To understand why, it is important to recognize that what matters for the economy is not the fed funds rate per se, but the interest rate that households and businesses actually pay.

... the average mortgage rate paid by homeowners is about three percentage points below the rate on new mortgages.

... even if rates on new mortgages decline, the average or "effective" mortgage rate will still rise as more new homebuyers are forced to take on high-rate mortgages. The process will also apply to businesses that will need to roll over loans they took out at favorable rates during the pandemic.

These dynamics will trigger more defaults, causing pain for the banking system. The problems that affected regional banks last year have not gone away. Commercial real estate loans continue to sour, and this trend will spread beyond office space to apartments, hotels, and shopping malls. ... Slower credit formation will sap growth.

No Help From Fiscal Policy Either

Some analysts have contended that stimulative fiscal policy will keep the economy out of recession. We think this argument is somewhat misleading.

It is true that the latest estimates by the Congressional Budget Office foresee the federal budget deficit reaching 7% of GDP in 2024, an exceptionally large number for an economy that is still close to full employment. A large budget deficit adds demand to the economy, lifting the neutral rate of interest in the process.

That said, it is equally true that US federal government debt is on an unsustainable trajectory. No matter what option is taken to address the debt overhang, the impact on growth will be negative. On the one hand, if the Fed is forced to effectively inflate away the debt by keeping rates artificially low, long-term bond yields will spike, crippling the housing market. On the other hand, if the government is forced to undertake austerity measures, aggregate demand will weaken, which will also cause growth to slow.

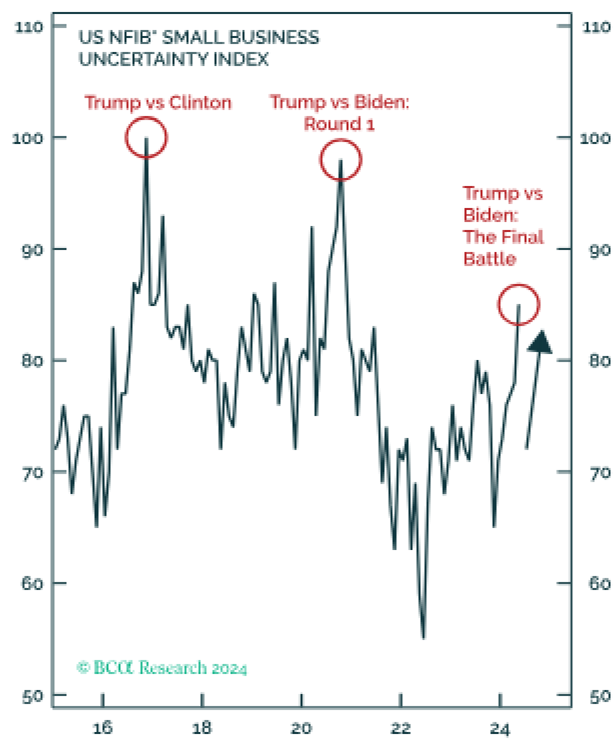
While the former option makes for splashier headlines, our guess is that the latter option will be pursued.

This is true even if Donald Trump wins in November (the odds of which increased after Biden's disastrous debate performance, as shown below). The bond market will respond to any serious talk of another unfunded tax cut with the same "talk to the hand" reaction that greeted the Truss government in the UK. Rising long-term bond yields will cause moderate Republicans to scuttle the deal, or to include spending cuts in any tax bill. Since the fiscal multiplier from spending is higher than for taxes, the net effect would be to lower aggregate demand.

An escalation of the trade war would not help matters. Business uncertainty has increased considerably over the past six months (**Chart 19**). If companies have little clarity about the future, they tend to invest less. This leads to slower growth.

CHART 19

Election Uncertainty In The Small Business Sphere Is On The Rise



* NATIONAL FEDERATION OF INDEPENDENT BUSINESS.

European Growth: Uneven Performance

Whereas the US economy continued to grow at a healthy pace in the second half of 2023, the euro area economy contracted slightly. While the economic picture has improved since then, the incoming data remains choppy. For example, while consumer confidence has improved, business confidence remains weak. And after a few months of stronger PMI prints, the May data on both manufacturing and services were disappointing.

There are certainly reasons to expect European growth to improve. Unlike in the US, Europe was hit by a massive energy shock following Russia's invasion of Ukraine. European inflation soared, causing real wages to crater. As inflation has come back down, real wage growth in the euro area has caught up with the US. In the UK, real wages are growing more quickly than in the US. This has injected some pep into the economy.

Moreover, European households have substantial amounts of excess savings. This translates into plenty of pent-up demand for consumer durable goods. Car registrations are still 28% below 2019 levels.

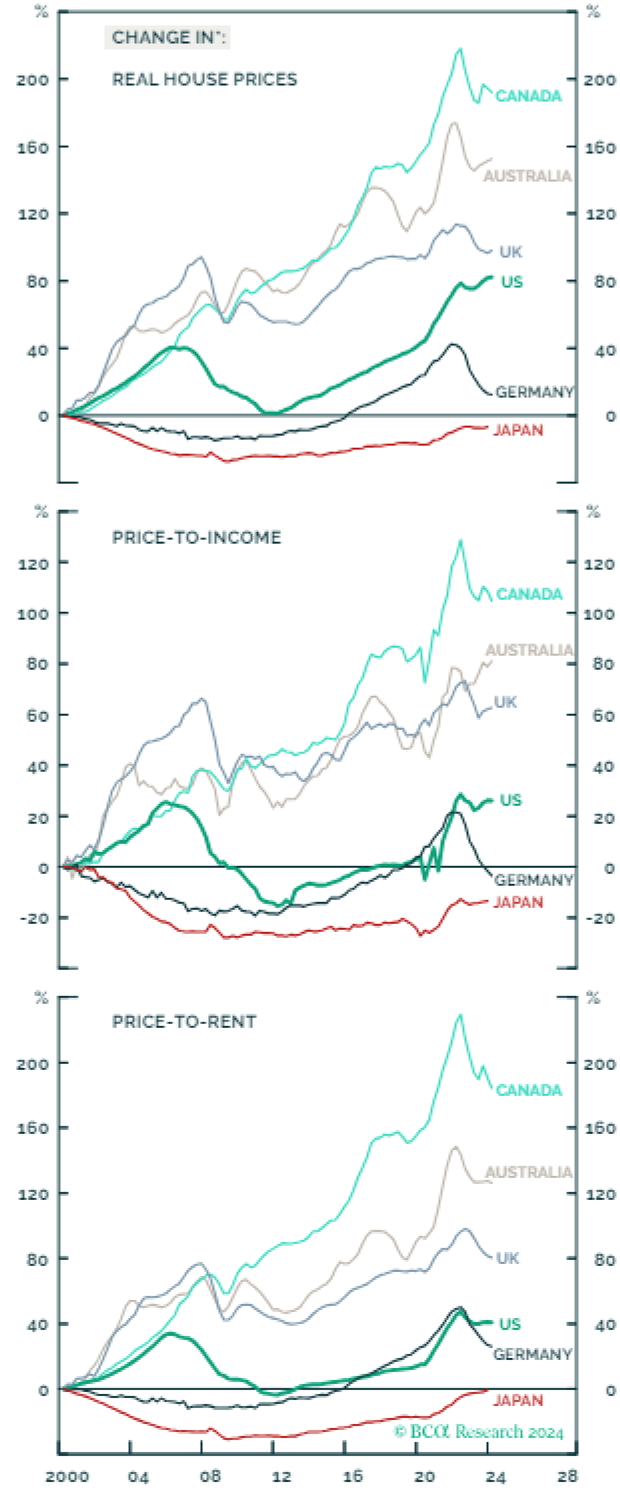
On the negative side, a large share of consumer loans in Spain and Italy will reset to higher interest rates. This will weigh on spending. In Germany, fiscal policy is set to tighten by around 1% of GDP. In France, political uncertainty could dampen investment spending at a time when capex intentions are already downbeat.

As in the US, the job vacancy rate is falling across the euro area. If the current trend persists, vacancies could drop by enough to trigger a meaningful rise in unemployment in 2025. Vacancies are also falling in the UK, which is likely to translate into weaker wage growth and smaller income gains.

Among the major developed economies, Canada and Australia are most at risk of an outsized recession. Households in both countries have faced a dramatic increase in interest payments. Both economies have overvalued housing markets that could weaken if unemployment rises meaningfully (**Chart 28**).

CHART 28

...And These Three Countries Also Have The Most Overvalued Housing Markets



* SERIES REBASED TO Q1 2000 = 0%. SOURCE OECD.

China: A Two-Speed Economy

The Chinese export sector has fared reasonably well this year. Export growth accelerated in May, rising to 7.6% year-over-year. In contrast, domestic demand remains subdued, weighed down by a weakening housing market. Home prices, sales, and starts are all falling.

Looking out, we do not expect any improvement in the housing market. Chinese home prices are still high in relation to rents. A shrinking working-age population will curb demand for new homes for years to come.

Meanwhile, export growth will decelerate, as is already being flagged by the recent decline in the export PMI.

Chinese export growth will slow further as external demand slows and protectionist sentiment abroad escalates.

The Chinese authorities have been cautious about stimulating the economy. The fiscal/ credit impulse remains mired in negative territory. According to BCA's China strategists, the much-ballyhooed RMB 500 billion in funding to enable state-owned companies to purchase vacant apartments amounts to only 4% of property developers' annual financing needs. Meanwhile, real lending rates have risen to multi-year highs as deflationary pressures have set in.

II. Financial Markets

A. Global Asset Allocation

Downgrading Global Stocks To Underweight

Our base case is that the US economy will fall into a recession by the end of 2024 or in early 2025. On average, stocks have peaked six months before the onset of a recession (**Table 2**). We were tactically bullish on stocks for most of last year, moved to neutral earlier this year, and are now ready to shift to underweight on both a short-term (1-to-3 month) and a medium-term (6-to-12 month) horizon.

TABLE 2
On Average, Stocks Have Peaked Six Months Before The Onset Of A Recession

RECESSIONS	S&P 500 PEAK* (MONTHS)	S&P 500 TROUGH* (MONTHS)	PEAK-TO-TROUGH DECLINE (%)
DEC '69 - NOV '70	-13	+6	-36%
NOV '73 - MAR '75	-11	+10	-48%
JAN '80 - JUL '80	0	+2	-17%
JUL '81 - NOV '82	-8	+12	-27%
JUL'90 - MAR '91	-2	+3	-20%
MAR '01 - NOV '01	-7	+18	-49%
DEC '07 - JUN '09	-2	+14	-57%
AVERAGE	-6	+10	-36%

* RELATIVE TO THE START OF NBER-DESIGNATED RECESSIONS.

Our decision to move to underweight on global equities comes a bit earlier than we had guided in past reports. ... the run-up in equity prices in recent weeks has pushed stocks even further into overvalued territory. ...

While rising recession risk is bad for stocks, it is generally good for bonds. We recommend that investors shift the proceeds of equity sales primarily into cash and high-quality long-duration government bonds (Which we don't recommend.).

B. Equities

How Low Will It Go?

We foresee the S&P 500 dropping to 3750 during the next recession. Such a drop would bring the index back to where it should be based on our estimate of the net present value of future earnings.

CHART 36
EPS Versus GDP Growth For US Companies

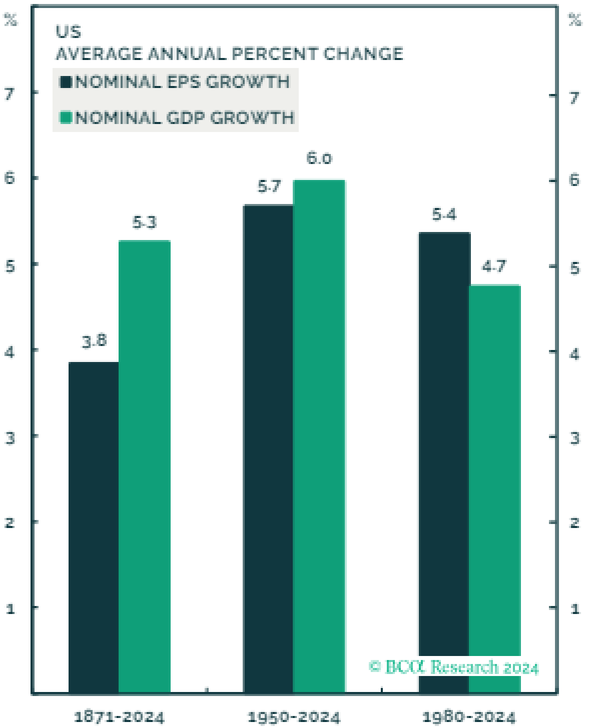
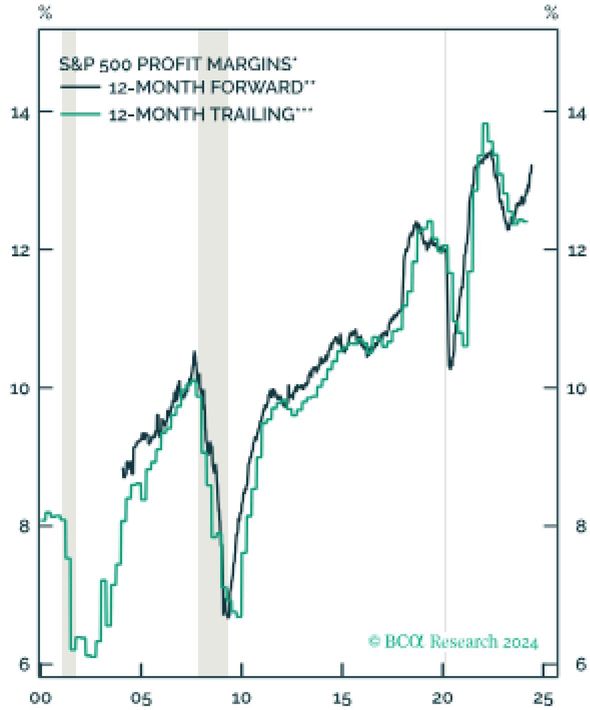


CHART 37
S&P 500 Profit Margins Are Elevated



* CALCULATED AS EPS / SPS.
** SOURCE: REFINITIV / IBES.
*** SOURCE: BLOOMBERG FINANCE L.P.
NOTE: SHADED AREAS DENOTE NBER-DESIGNATED RECESSIONS.

Our fair value calculation is quite conservative in that it simply assumes that S&P 500 revenues rise in line with nominal GDP. That may be too optimistic.

Chart 36 shows that EPS growth has lagged nominal GDP growth by 1.4 percentage points, on average, since 1871.

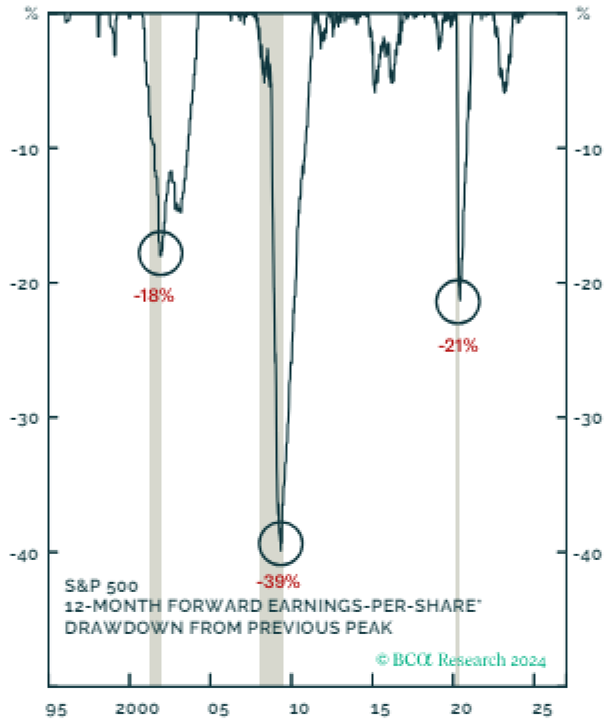
EPS growth has exceeded GDP growth since 1980. However, profit margins expanded considerably during this period, thanks to lower effective corporate tax rates, a decline in the labor share of overall national income,

TABLE 4
In A Recession, The S&P 500 Could Fall To 3750

	Hypothetical Change In Forward Earnings Estimate From Current Levels (%)						
Forward PE	-30	-20	-10	0	+10	+20	+30
10	1814	2073	2332	2591	2850	3109	3369
11	1995	2280	2565	2850	3135	3420	3705
12	2177	2488	2799	3109	3420	3731	4042
13	2358	2695	3032	3369	3705	4042	4379
14	2539	2902	3265	3628	3990	4353	4716
15	2721	3109	3498	3887	4276	4664	5053
16	2902	3317	3731	4146	4561	4975	5390
17	3084	3524	3965	4405	4846	5286	5727
18	3265	3731	4198	4664	5131	5597	6063
19	3446	3939	4431	4923	5416	5908	6400
20	3628	4146	4664	5182	5701	6219	6737

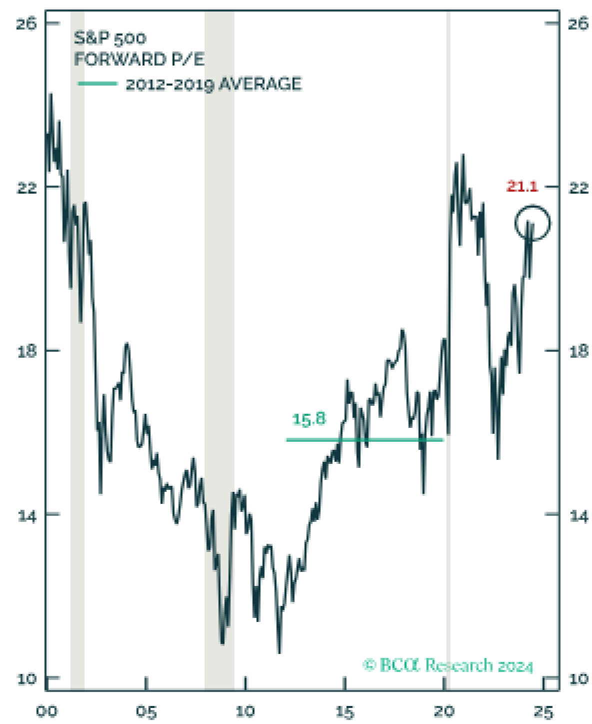
NOTE: AS OF JUNE 26, 2024. SOURCE: REFINITIV / IBES.

CHART 39
Our Assumption Of A 10% Decline In Earnings Estimates Is Quite Mild By The Standard Of Past Recessions



* SOURCE: REFINITIV / IBES.
NOTE: SHADED AREAS DENOTE NBER-DESIGNATED RECESSIONS.

CHART 40
The Drop In The P/E Ratio To 16 Would Still Leave It Slightly Above The 2012-19 Average



SOURCE: REFINITIV / IBES.
NOTE: SHADED AREAS DENOTE NBER-DESIGNATED RECESSIONS.

higher overseas profits, and a rising proportion of high-margin companies in the S&P 500 index (**Chart 37**).

It is difficult to know how these forces will evolve, but nothing in economic theory suggests that profit margins should continue to increase indefinitely. That could be a problem for stocks, given that analysts currently expect earnings to grow by 17% per year over the long haul.

Our 3750 target assumes that 12-month forward EPS estimates fall by 10% from current levels (**Table 4**). This would be much less than during the last three downturns (**Chart 39**). Our target also assumes that the S&P 500 forward P/E ratio drops to 16. Keep in mind that the forward P/E ratio averaged 15.8 between 2012 and 2019, a period that did not even include a recession (**Chart 40**). ...

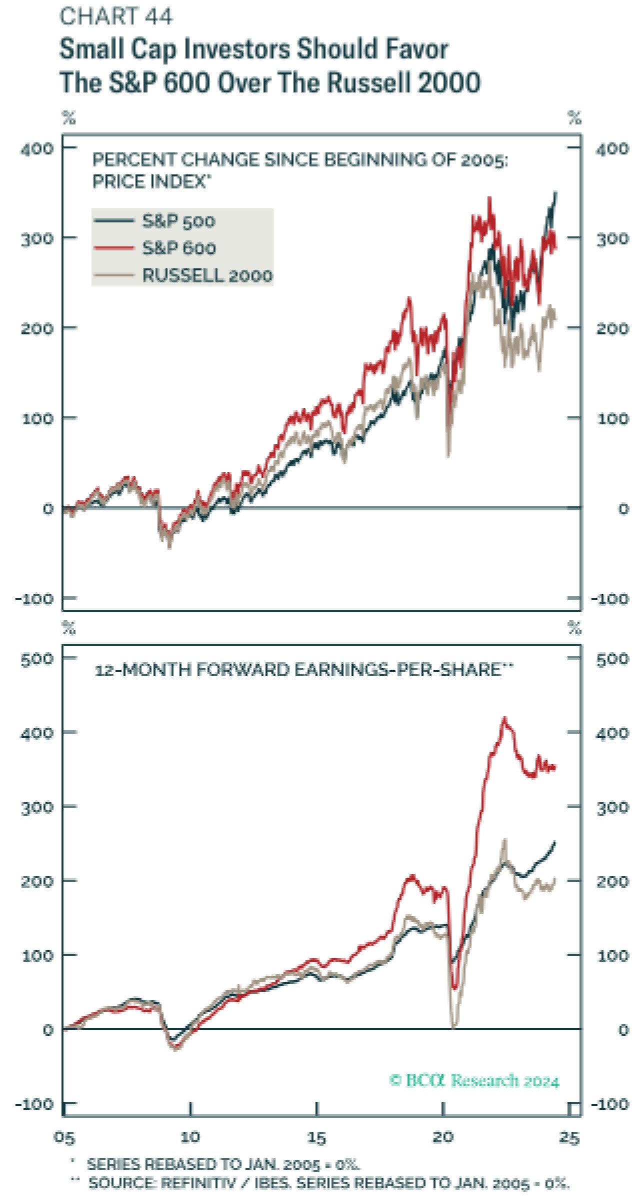
Within the Small Cap Realm, Favor the S&P 600 Over the Russell 2000

Small caps tend to have a somewhat higher beta to the market than their large cap brethren. Thus, a recession would disproportionally hurt smaller companies, many of which have highly cyclical businesses and are very reliant on bank financing. That said, small caps are trading at a steep valuation

CHART 43
Small Caps Are Extremely Cheap

discount to their large cap counterparts, which limits relative downside risk (**Chart 43**).

For investors looking to maintain exposure to small caps, we recommend favoring the S&P 600 (which includes an Earnings Quality Factor, as previously shared) over the Russell 2000. (This has been HCM's recommendation from inception.). The latter index has many more unprofitable companies, and hence scores lower on most quality measures. The Russell 2000 has also seen much slower earnings growth and price appreciation than the S&P 600 (**Chart 44**).



US Equities Should Outperform During the Next Recession, But Not By Much

US stocks typically outperform during recessions. This is partly because they are somewhat less cyclical than non-US stocks. It is also because most equity investors do not hedge currency risk when buying foreign stocks, thus benefiting from the tendency of the US dollar to appreciate during times of global economic stress. While our base case is that US stocks will outperform during the coming global recession, we do not think they will do so by a wide margin. US equities are very expensive in relation to non-US stocks. Moreover ... the US dollar's appreciation will be somewhat muted during the next recession. ...

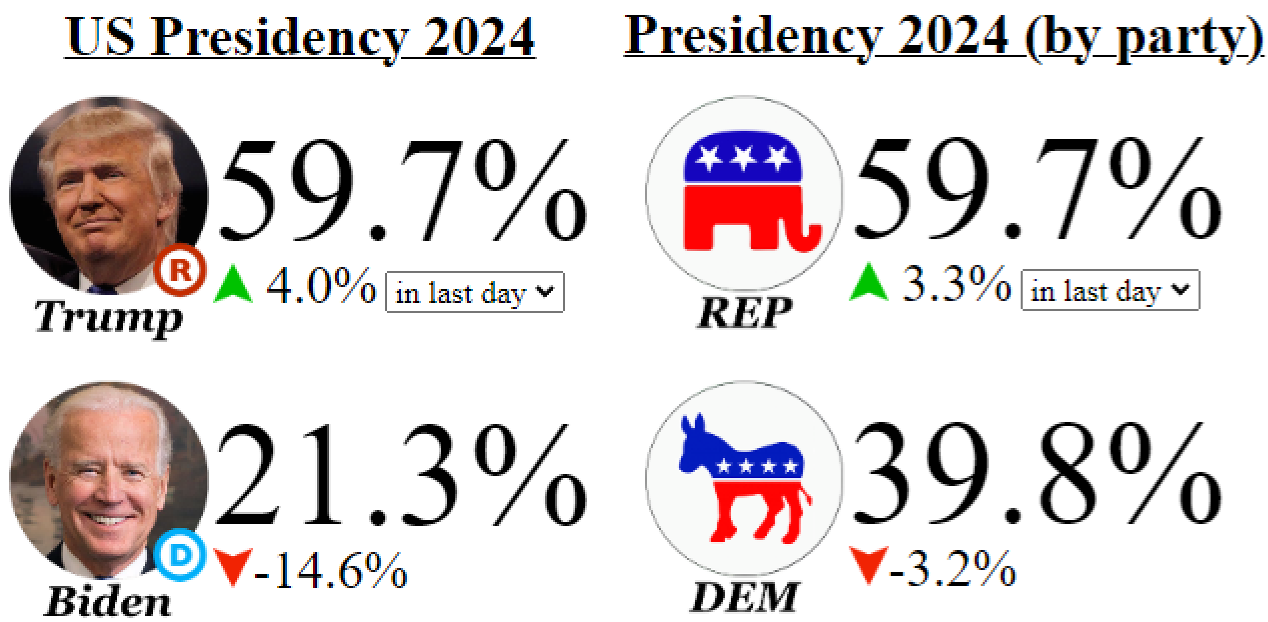
From Bespoke:

... The Aftermath

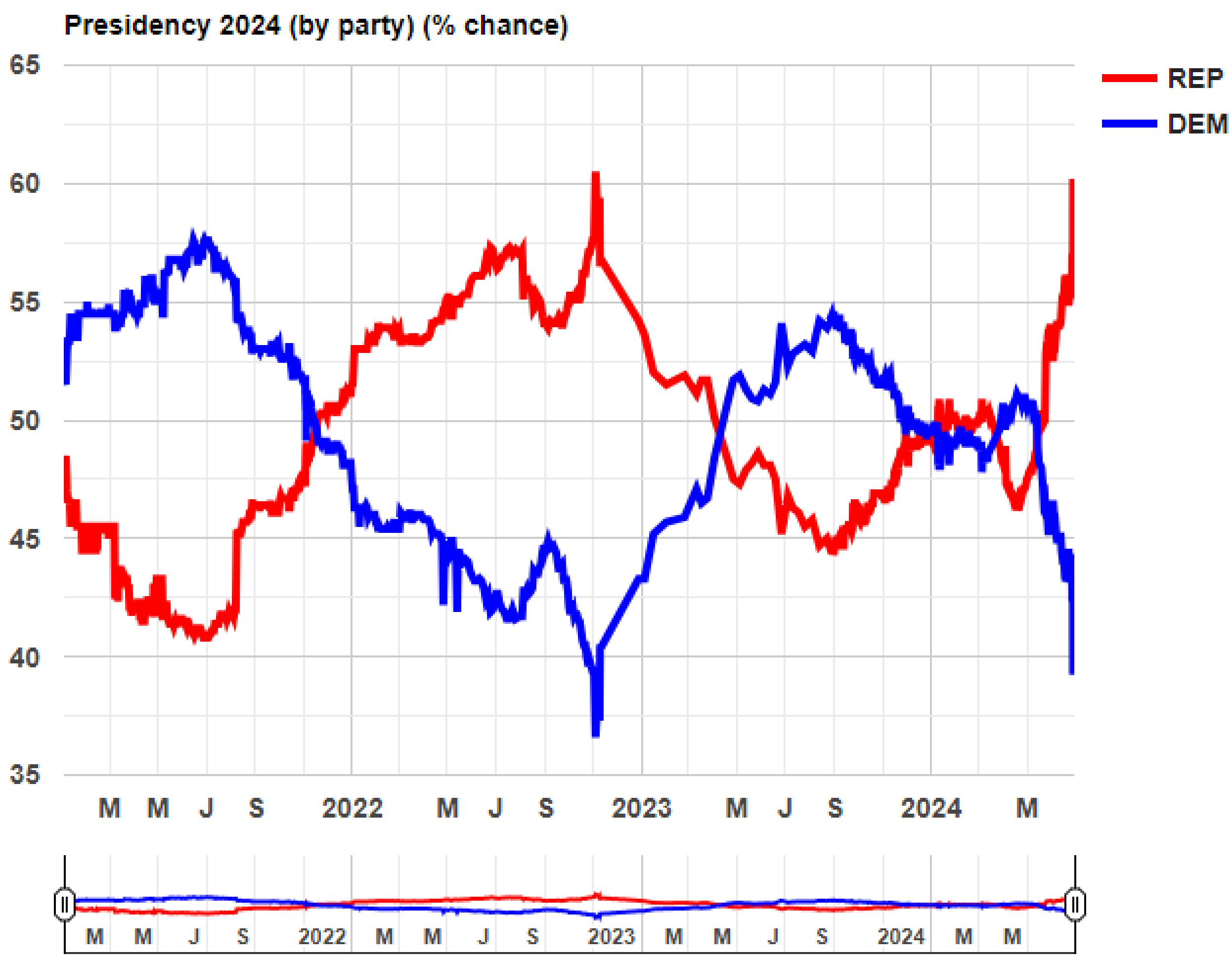
Fri, Jun 28, 2024

In yesterday's Morning Lineup note we noted that "barring something completely unexpected, it's hard to see this night being looked back at as a major milestone come November." Last night's debate met the bar. *Politico* called it the "worst performance of any general election presidential candidate in any debate in modern American history." *NBC News* noted that it sent "Democrats into a panic". A *New York Times* headline described it as "frightening", "shaky", and "halting". *CNN* referred to it as 'disastrous'. On the other side of the Atlantic, *Sky News* called it "excruciating" and said that some Democrats described it as a "car crash", *BBC* called Biden's performance "incoherent", and *The Economist* described it as "horrific" and "casts his entire candidacy into doubt". Keep in mind, that these aren't publications that are typically known as leaning conservative.

The initial reaction in the betting markets was swift. As shown in the snapshot from electionbettingodds.com, while Trump's odds of winning increased 4 percentage points to 59.7%, Biden's chances plummeted by nearly 15 percentage points to 21.3%. Interestingly, though, on a generic party basis, Democratics odds declined by just 3.2 percentage points as the chances for a candidate other than Biden on the Democratic side grow.

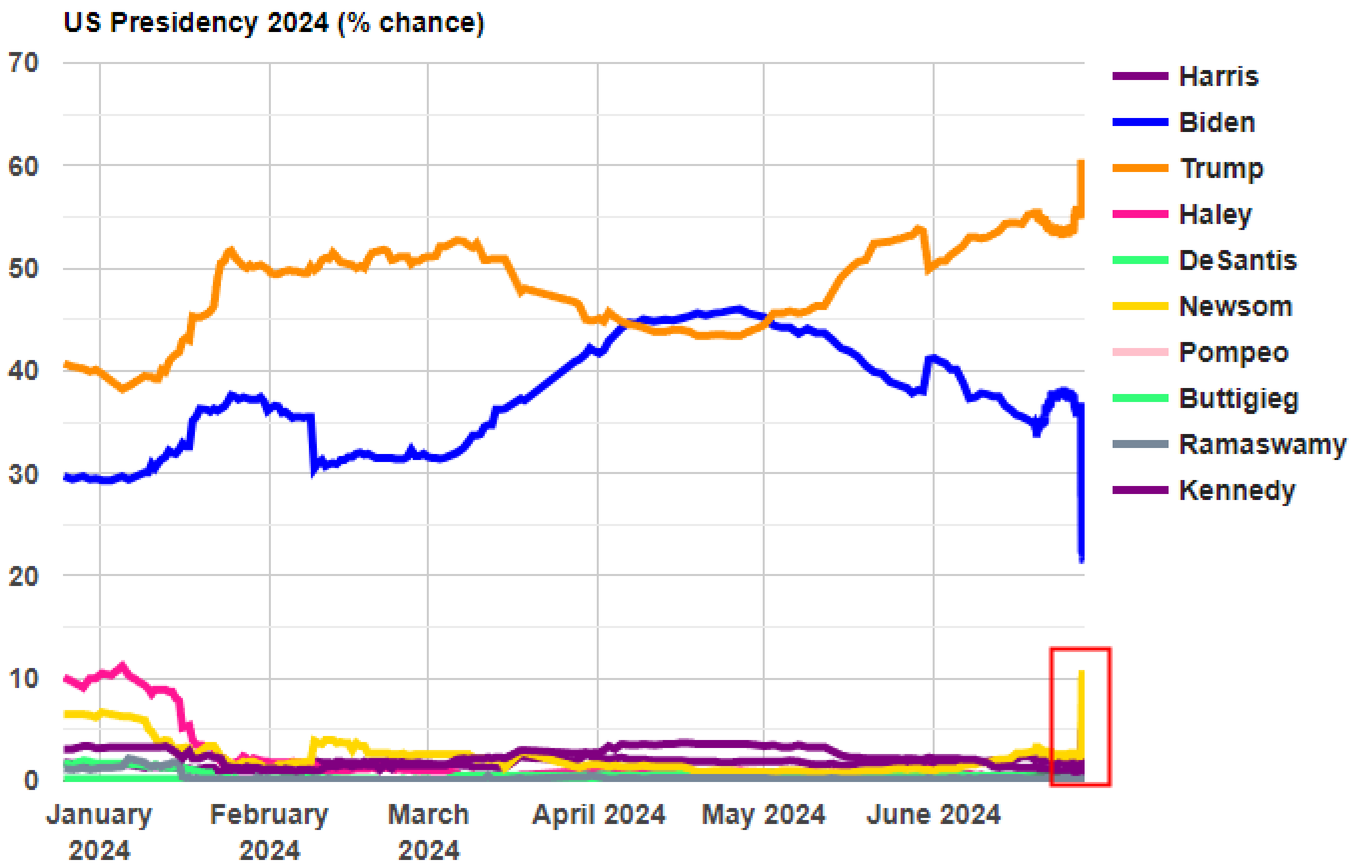


While the Democratic versus Republican party matchup didn't move nearly as much as Biden's odds, it was a



big move relative to history. As shown in the chart above, the odds of a Republican victory in November are right near the highest levels since at least 2022, and the only time the odds were higher was in late 2023.

The reason Biden's odds had such a large decline relative to Trump's increase comes down basically to one person- Gavin Newsom. As shown in the chart below, overnight, Newsom's odds of being elected in November shot up to 10% for the first time, and he's now nearly half as likely to be elected in November as Biden! Obviously, it's still early and a lot can and will likely change between now and November. If you identify as Democrat, Republican, or unaffiliated with either party, if you watched last night's debate, you won't forget it.



Follow-ups

Two from the WSJ:

Hot Funds and the Curse of 'Self-Inflated Returns'

When billions of dollars gush into an ETF that just reported big gains, more gains can soon follow. The problem: The investors themselves are driving those gains—and will suffer when their impact fades.

By Jason Zweig
June 14, 2024

What your exchange-traded fund owns is important. Who else owns your ETF might be even more important.

That's because a fund's returns often don't depend merely on the behavior of the investments it buys, but also on the behavior of the investors who buy the fund.

Hot money—a sudden influx of cash from people trying to get rich quick—can overheat an ETF and create what new research calls "self-inflated returns." The result, sooner or later, is self-inflicted losses. Fortunately, you can protect yourself with some common sense.

What are self-inflated returns?

They start when a fund generates a burst of high performance. Maybe an "active" ETF run by stock pickers buys a few big winners. Or maybe a passive fund that holds everything in a benchmark tracking one market segment has gotten hot.

In either case, people notice. They buy the fund in droves, pouring in hundreds of millions or even billions of dollars. The ETF's managers take that cash and pump it into the stocks the fund already owns.

If those stocks are small and thinly traded, the fund's own buying will drive their prices up. That will raise its return again, attracting even more money from performance-chasers, pushing the prices of the fund's stocks even higher and drawing in another blast of hot money.

A new study—by Philippe van der Beck, a finance professor at Harvard Business School, and Jean-Philippe Bouchaud and Dario Villamaina of Capital Fund Management, a Paris-based investment firm—looks at how this cycle feeds on itself.

As the researchers put it, "Investors chase their own impact."

The study hasn't yet been published in a peer-reviewed journal, but I think the findings are solid.

Over the years, many portfolio managers have told me that large inflows at a fund that concentrates on smaller, less-liquid stocks can drive prices up if the fund's buying constitutes much of the typical daily volume in those stocks.

This self-reinforcing cycle can delude investors into thinking a fund's return is generated solely by the manager's skill—when, in fact, it comes largely from the behavior of the fund's investors themselves. Self-inflated returns can push prices higher and persist longer than you might imagine—although they're bound to fade eventually.

Part of the study focuses on an ETF whose name the researchers won't disclose. I'm almost certain that it's ARK Innovation, the "disruptive innovation" fund actively managed by Cathie Wood that earned one of the highest returns in history when it gained 153% in 2020.

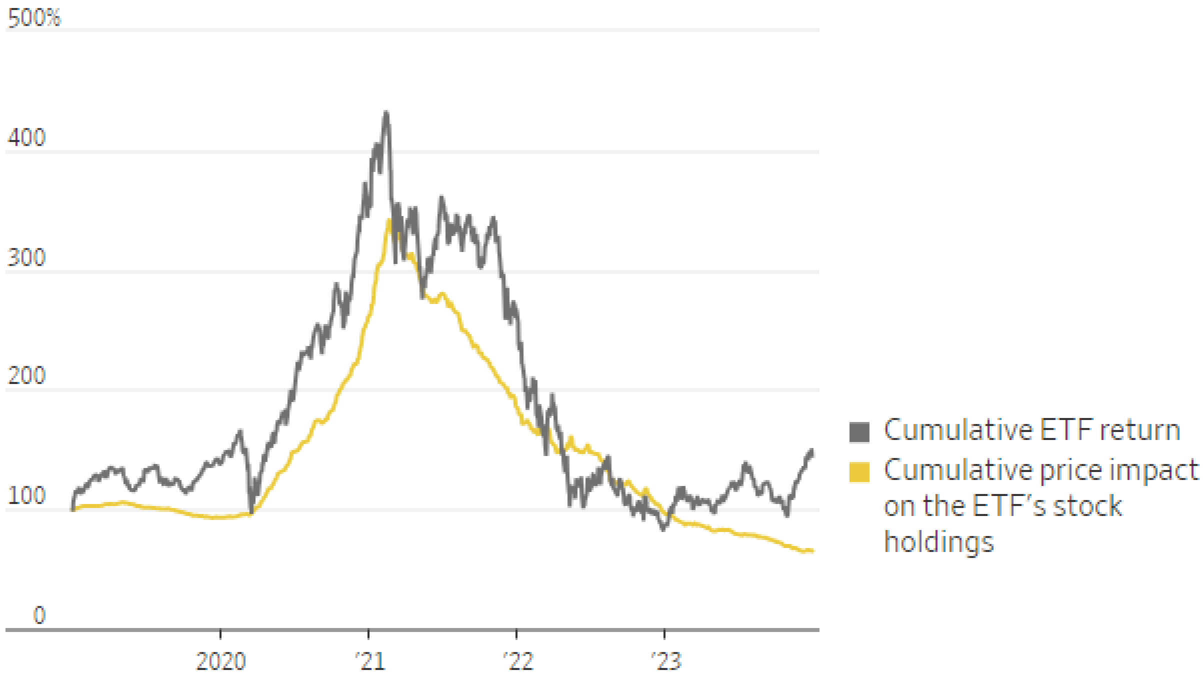
As of October 2019, ARK Innovation had nearly one-quarter of its $1.6 billion in assets in nine stocks. It owned more than 5% of the total shares at each of them. Such larger positions in smaller stocks included 9.9% of genome-editing company Intellia Therapeutics and 5.1% of genetic-testing firm Invitae.

As ARK Innovation's returns flared up, investors pumped money in. In 2020, its assets ballooned more than ninefold from $1.9 billion to $17.7 billion. As ARK redirected that tidal wave of cash into its favorite stocks, Intellia rose 271% and Invitae 159%.

Pumped Up

When researchers examined this anonymous ETF, they found that a large part of its performance could be explained by the investors pouring into—and then retreating from—the fund

ETF performance and the effect of net flows on its stock holdings



Source: Philippe van der Beck et al.

Sooner or later, though, performance falters, the hot money flees and managers have to dump stocks. That pushes down the prices of those stocks, worsening the fund's performance and sending even more hot money stampeding out.

ARK Innovation's assets peaked at about $25.5 billion in mid-2021 and have shriveled to $6.3 billion. The fund has lost an average of 27.9% annually over the past three years. Intellia and Invitae are down an average of 30.1% and 96.9% annually over the same period.

ARK declined to comment.

But its funds aren't alone. On average, at the biggest, most-concentrated ETFs, 8% of the variation in performance over time can be attributed to what van der Beck calls "an increase in price generated by the funds' trades as money comes in from their own investors."

The study shows that an ETF whose return is 10% better than average over a given period will increase its inflows by 2%—half of which comes within two months of the reported outperformance.

It also shows that self-inflated returns fade and reverse—but the exact timing is unpredictable.

Chasing momentum feels great on the way up; just ask anybody who bought GameStop at the beginning of this month when online influencer Keith Gill touted the stock again. But knowing just when to jump off is hard; GameStop fell from its peak by almost half in a couple of days.

“Everyone wants to be in on the virtuous part of the cycle, but not its evil twin,” says investment analyst Tom Brakke.

Common sense is your best guide.

First, beware of funds that deviate drastically from a broad market index by holding only a few dozen stocks or lots of smaller companies. Those features are the breeding ground for hot returns and the hot money that chases—and inflates—them.

Check whether holdings are “capped,” or limited to a fixed proportion of a market index—often somewhere between 2% and 5%. That should prevent the fund, no matter how popular it gets, from pouring too much money into its hottest stocks.

Steer clear of ETFs whose top holdings are heavily sold short by hedge funds and other traders betting on a decline. You can check the short interest in any stock on most market websites or brokerage apps.

Finally, watch out for rapid growth.

When billions of dollars gush into a small fund that just reported big gains, self-inflated returns are likely to follow.

Let other people chase them. In the end, all they’re likely to end up with is self-deflated returns.

When Past Performance Doesn’t Even Predict Past Performance

Wall Street likes to tout returns it didn’t actually produce. You need to ask some important follow-up questions.

By Jason Zweig
May 31, 2024

This week, the Dow Jones Industrial Average, born on May 26, 1896, turned 128 years old. Let’s pour the Dow a drink from the fountain of youth and see what happens.

I’ll give you a hint. The lesson here isn’t only about markets, but also about marketing—in particular, what’s called backtesting, a statistical dirty trick that’s central to Wall Street’s marketing playbook.

And we can use the Dow, which this year has been drastically underperforming its younger cousin, the S&P 500, to help explain how the pros try to pull the wool over your eyes.

Consider the way the indexes are constructed. The Dow is price-weighted: The higher a company’s share price, the more it contributes. Stocks in the S&P 500, by contrast, are weighted by their total float-adjusted market value: share price multiplied by the number of shares that trade publicly. (The Dow, originally owned by Dow Jones, publisher of The Wall Street Journal, is now owned by S&P Dow Jones Indices, but two Journal editors sit on the index committee.)

So Boeing, for instance, is 2.9% of the Dow. That puts it barely behind Apple at 3.3%—because Boeing’s $172 share price is close to Apple’s $190. That’s why Apple doesn’t have a huge impact on the Dow.

But Apple's adjusted market value, $2.76 trillion, is 28 times greater than Boeing's $98 billion. This makes it far more meaningful to the S&P 500.

Add up the share prices of the Dow's 30 stocks, and you get something like $5,850. A new stock at $1,000 a share would constitute 17% of the basket—single-handedly unbalancing the entire benchmark.

That's what Howard Silverblatt, senior index analyst at S&P Dow Jones Indices, calls "1896 mathematics." It effectively precludes the Dow from adding such stocks as Eli Lilly (recent price: $815, up 40% year-to-date) or Netflix ($648, +33%).

All this got me thinking: How would a fantasy Dow consisting of the 30 highest-priced stocks have performed?

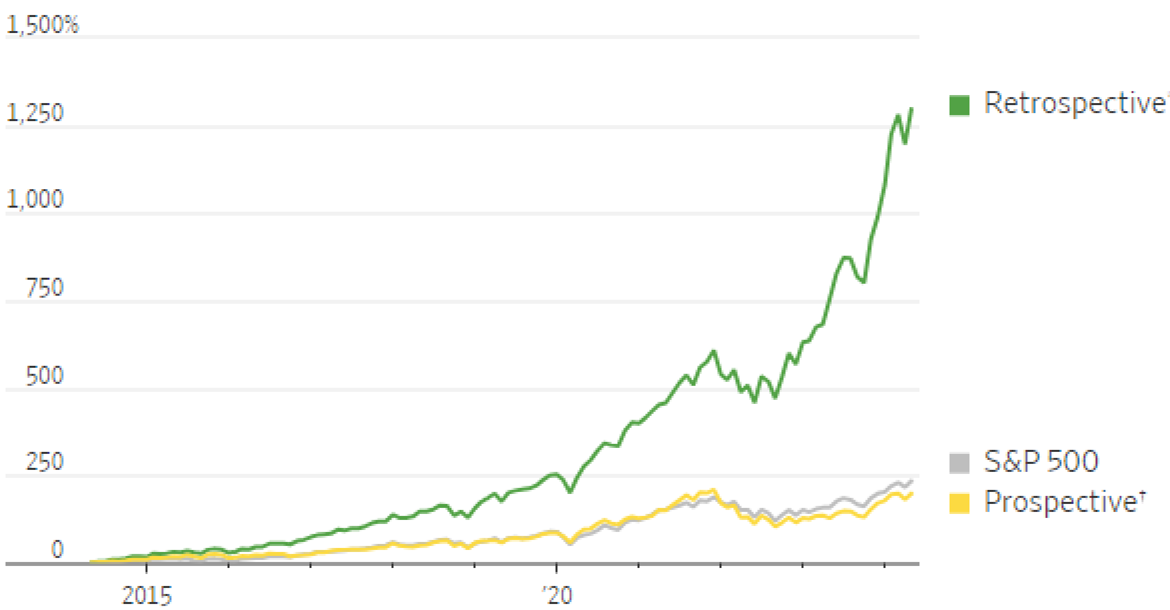
Let's call it the Supersized Dow. Out with Intel (share price: $30), Verizon Communications ($40) and Cisco ($46). In with NVR ($7,455), Booking Holdings ($3,755) and 28 other stocks with supersized prices, including Lilly, Netflix and Nvidia.

Over the past 10 years, this Supersized Dow would have returned an average of 30.2% annually, versus 11.4% for the real-world Dow and 12.8% for the S&P 500, according to John Jacques of AJOVista, an investment firm based in Boston.

Divergent Dows

The Dow Jones Industrial Average lacks the high-priced stocks that have recently outperformed. How well would it have done if it instead consisted of the 30 stocks with the highest share prices? That depends on whether it selected the highest-priced stocks today or in the past.

Cumulative returns



*For the 30 highest-priced stocks today †For the 30-highest priced stocks 10 years ago
Source: AJOVista

A $10,000 investment would have mushroomed to almost $140,000 in the Supersized Dow—but to less than $34,000 in the S&P 500.

What's the catch? Why can't you pulverize the market just by buying the stocks with the highest share prices?

Because of backtesting. The Supersized Dow would have outperformed only if, at the beginning of the period, you bought the stocks that happened to have the highest share prices *at the end of the period*—something no one could possibly predict.

If, 10 years ago, you had bought the stocks with the highest share prices *then*, you'd have underperformed the S&P 500 by an average of 1.3 percentage points annually.

That assumes you adjusted the portfolio each Jan. 1 so it held the 30 highest-priced stocks as of that date—as would be logical if you tried this in real time. You also had to trade for free, reinvest all dividends and pay no taxes.

By backtesting—applying hindsight to past data and pretending that a hypothetical portfolio had been run that way all along—financial marketers can make outperformance look ridiculously easy.

Take the five target-date funds run by Brandywine Asset Management of Thornton, Pa. These funds seek greater risk when savers are young, scaling back as investors approach or exceed retirement age.

Brandywine's funds use put options, which go up when stocks go down, to try mitigating losses in a market crash. In theory, that can provide an edge.

If you'd invested $10,000 in January 2013, you'd have had $23,091 in Brandywine Target Retirement at the end of March 2024—but only $16,064 in its average competitor, according to the firm.

The only trouble is, you couldn't have invested in the fund in January 2013, because it didn't exist. That track record is backtested and largely hypothetical.

The fund didn't begin operating until October 2023. The past returns show how the fund would have performed if it had existed ever since January 2013, partly based on other accounts Brandywine ran at the time.

From July 2018 until May 2020 and again in March and April 2023, the firm didn't have actual results from the strategy, so those periods are simulated, says Brandywine's chief executive, Michael Dever.

"If you're managing money, the only thing that matters is accuracy," says Dever. "We think we've come up with a very accurate representation of what we expect to be able to achieve performance-wise."

Since its launch in October, the fund has outperformed its benchmark by 2 percentage points with less fluctuation, according to Brandywine.

"So far it's been doing exactly what the back performance says it should," says Dever. "We'll know for sure in another 10 years."

The Brandywine funds are only the tip of the backtesting iceberg.

Asset managers often roll out exchange-traded funds based on such factors as "liquidity" or "revenue" that appear to have worked in the past, but flop in the real world.

Insurance companies have sold billions of dollars of annuities, universal life and other products linked to customized indexes with high past "returns" that soon fade.

Of course, you can't completely ignore the past when you project the future. To protect yourself against backtests that foretell nothing, ask questions like these:

If this idea is so great, why weren't these guys using it at the beginning of the period instead of only at the end? Why wasn't everybody using it?

How long has the strategy actually been used, and with how much money? Has it been tracked over even longer periods than reported in the backtested data? How many other strategies were backtested but abandoned? Do the past numbers include trading costs?

If the answers don't make sense, don't invest.

Positions

Despite our oft-repeated qualms about attempting to time the markets, we continue to allow cash to accumulate in client accounts unless presented with compelling opportunities. Two such opportunities came in June:

GRNT - On 6/24 we purchased 1% positions in this Non-operated O&G stock for 6 clients @ 6.095:

Insider Buying:

Trade Date	No. Part	Participants	Net Sell (Shares)	Net Buy (Shares)
06/17/2024	1	Miller Matthew		483
06/14/2024	3	Darden Thaddeus, Brande...		20,500
06/06/2024	1	Darden Thaddeus		3,000
06/03/2024	1	Miller Matthew		7,700
05/23/2024	2	Perry Griffin, McCartney ...		2,500
05/21/2024	1	McCartney John		1,000
05/20/2024	1	Everard Michele		1,000
05/17/2024	1	McCartney John		500
05/16/2024	1	McCartney John		500
05/14/2024	2	Brandenberg Luke, Farqu...		10,000

From Z4 ENERGY RESEARCH, whose most recent purchase was on 6/17 @ 5.86, on May 14th:

- On our 2024 Base Case the name trades at **2.9x** and we view this as overly cheap in light of the balance sheet and implied yield of **7.1% (we assume they maintain the $0.11 per quarter rate)**. Our view is this in the non operator discount we often see and maybe a multi play discount as well. Their biggest position is the Permian but they have significant acreage, production, and reserves from the Bakken, Eagle Ford, and Haynesville as well.

- Management is looking to erode the non operator discount by migrating from pure Non Op mode to a hybrid non op and controlled capital strategy. In 2024 over 40% of total D&C capex will be directed to controlled capital programs in the Permian where they have an inventory of 21.9 net wells.
  - Over time they plan to have well over half their annual capex tied to controlled capital partnerships.
- Controlled capital is capital allocated to private player development programs where GRNT gains control over development timing vs traditional non operator model where the non op either consents to drilling when operator calls or goes non consent.
  - **Catalyst Watch:** There is a pad of short lateral wells from this program set to be TIL'd in June. Will be interesting to hear if they can block up some of the acreage in the Permian for longer lateral drilling or if their operators would consider horsehoe wells.

- The company has a busy marketing schedule ahead and could see more sellside coverage this year as they are attending some conferences where they don't have coverage. Management is very focused on getting the story in front of more investors and analysts.
- The shares slumped almost 4% on a weak day for the group on Friday and we added a little more. GRNT is still thought of a Trade Only idea. It is currently our 3rd largest holding and we have an average cost, excluding dividends, of $5.87.
- Our view is that over time the TEV/EBITDA discount will erode as investors learn about the story and as the controlled capital program bears replicable results (either via growth or via the monetization of assets for higher than non operated tied multiples).
  - **Caveat Watch:** Gray Rock's sale in September of last year of just over 5% of the shares, at a deeply discounted $5.00, is the event that tanked the shares and caught our attention. Gray Rock still has 52% or ~67.9 mm of the shares here.

SUN - On 6/4 we purchased 2% positions in this Fuel Distributor yielding 6.9% for 4 clients @ 50.48:

Insider Buying:

Trade Date↑	No. Part	Participants	Net Sell (Shares)	Net Buy (Shares)
05/29/2024	1	Harkness Austin		1,000
05/24/2024	2	Hand Brian, Fails Karl		5,000
05/23/2024	1	Kim Joseph		5,000