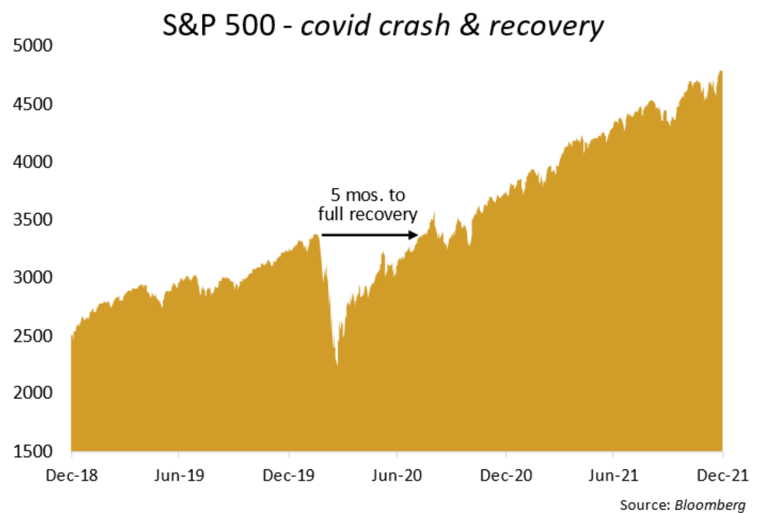
Where were you four years ago?

Just kidding, we know where you were. If you weren't pacing empty aisles in search of a forgotten bundle of toilet paper, or trying your hand at cutting hair, or making calls to get out of the summer vacation you'd booked the month before, you were undoubtedly sitting at home like everyone else. Regardless, you were living a life that you couldn't have envisioned just weeks earlier, with little sense of how or when things would get back to how they're supposed to be.

The covid-19 outbreak also threw financial markets into a state of disarray, just like the subprime crisis had done barely a decade earlier, with stocks falling sharply against a relentless stream of disconcerting news. Equipped with lessons from the last financial calamity, however, policy makers acted with unmatched swiftness and force to dampen the effects of the pandemic, and soon we found ourselves living in an odd, suspended economic reality.

Though monetary measures implemented during the pandemic weren't novel – *slashing policy rates, buying bonds in the open market to compress mid and long-term yields, opening taps to keep the financial system liquified* – the fiscal impulse was, both in its form and in its scale. Rather than stimulating activity indirectly through infrastructure projects or tax cuts, cash was instead funneled straight to households and businesses and deficits were allowed to balloon with the view that, whatever undesirable consequences might be sown, they were dwarfed by the potential catastrophe we were facing in the moment. While it can be argued that the largesse was too great in volume or that it was kept in place too long, it's undeniable that it prevented a massive economic contraction that would have devastated many families and businesses. It also allowed stocks to fully erase their initial plunge within just a few months:



Source: *Bloomberg*

In fact, the market's recovery was so swift that anyone selling in the downturn to avoid further pain would have almost certainly been left behind by the rebound. Pondering the chasm in the accompanying chart, it's difficult to imagine that *anyone* had the dexterity or fortitude to both sell in the crash and then re-buy at a lower level.

Things continued to go well for stocks for the next couple of years, until the covid crisis was replaced by the "cost of living" crisis. As it turned out, the price of all that money creation and the concurrent jump in consumption came in the form of inflation, and the accompanying spike in interest rates triggered a 25% decline in the S&P 500 through the first three quarters of 2022. This setback convinced many that the recovery from the pandemic low had run its course and so investor sentiment took a nosedive, with uninvested cash

balances exploding in sympathy (as we noted in our last commentary, professionals weren't immune to the pessimism, with Wall Street collectively predicting a negative calendar year for the S&P 500 for the first time in nearly a quarter century … of course, 2023 turned out to be anything *but* negative).

Fast forward to today and both the S&P and TSX have established new highs, after rallying as much as 45% from late 2022 levels. Though the covid and inflation driven bear markets were different in their causes, depth, and recoveries, they reinforced the paramount determinant of successful equity investing: *own quality and stay invested!* Though we're acutely aware that we've repeated this message to the point of monotony, it nonetheless remains one of the most important ones we know.

Today, the principal bearish complaint is that the market's rise is too reliant on a small group of companies, colloquially labelled the "Magnificent 7", and that this narrowness will soon be the rally's undoing. While it's true that these stocks have accounted for an outsized share of the S&P's latest leg up, it's also true that they're making an outsized contribution to the benchmark's aggregate earnings. As well, market breadth may not be as bad as we're led to believe: within days of the S&P 500 reaching its all-time high, the equal weight version of the index did the same, showing that even when the smallest company is given the same priority as the largest, the uptrend remains. For those worried that winners are overly concentrated by style or sector, both the Russell 1000 Value Index and the Russell 1000 Growth Index also reached fresh historic highs at the end of the quarter; as well, the DM US Equity Fund beat the S&P 500 by 5.3% over the past 12 months, despite not owning three of the five biggest contributors to the market's return. Instead, we were able to find opportunity in less obvious places, like Domino's Pizza (+53%), Carlisle Cos. (+75%), and TopBuild (+112%).

A word on artificial intelligence and what it means for your portfolio

Speaking of market leaders, Nvidia – the maker of AI-oriented chips – has quickly become a market unto itself, with the company now worth more than several major stock exchanges and sporting a value greater than the GDP of every country in the world, but seven. We don't mention this to disparage the firm or the price of its shares, however. In fact, Nvidia is a great company with a great culture and profit growth that keeps its valuation at least within sight of terra firma. We've looked at the stock extensively in the past (even when it was best known as a maker of graphics drivers for gaming), but never quite got the point of pulling the trigger. Of course we lament the missed opportunity today, but we also know that, just as running concentrated portfolios means that our best ideas won't be diluted by the market's also-rans, it also means that we can't possibly own every winner.

Artificial intelligence is being hailed as a major economic watershed, potentially as impactful as the introduction of the internet or the mass adoption of mobile telephony. In your portfolio, holdings such as Microsoft and Alphabet are busily building AI tools and already turning them into earnings, while companies as diverse as Visa and Thomson-Reuters are exploring ways to incorporate the technology into their businesses. These are exciting times in the space, but it is still *very* early innings and the companies in the lead today won't necessarily be those that wind up on top in the end *(anyone remember how AOL and Netscape once dominated the internet or how Nokia, Ericsson, RIM, and Motorola made all the coolest cell phones?).*

Even with all the excitement bubbling through

the sector and the rush of capital into it, it hasn't been an easy investment. In fact, according to the Wall Street Journal, among 17 ETFs specializing in AI and related disruptive technologies, only three managed to outperform the S&P 500 over the past year. Fortunes will undoubtedly be made and lost in AI, but because of risk, uncertainty, and complexity associated with the sector, we're unlikely to diverge from our cash flow and valuation discipline in pursuit of any company which is primarily levered to this still very nascent industry sub-set.

Following an unexpectedly strong 2023, this year is also off to a good start for DM mandates, with our small cap, Canadian, and US equity portfolios all well ahead of their long-term trends. The changes we've made in equity allocations over the past three months have mostly been geared toward risk reduction, with profits trimmed from stocks which have risen above our intrinsic value estimates and capital added to those which we believe represent a more favourable risk/reward tradeoff. Bond prices, on the other hand, sagged in Q1 as inflation diverged from the downward path it had followed for a year and a half. Despite outperforming its benchmark, the DM Bond Fund unfortunately posted a small decline over the past three months.

Revisiting our earlier comment about the importance of staying invested, especially when market behaviour or world news *(or even the opinions of respected friends)* are tempting you to do the opposite, consider the following. During his tenure as lead portfolio manager of the Fidelity Magellan Fund from 1977 to 1990, investing legend Peter Lynch generated an astonishing annualized return of 29%. Even so, a study by Fidelity found that the average investor in the fund lost money over that span. Yes, you read that correctly – though the fund turned an initial investment of $100,000 into $2.7 million, John and Jane Smith somehow managed to finish with less money than they had at the start. *How could that be?* Well, like any equity investment, the Magellan Fund didn't follow a straight path to glory. In fact, in the 13 years that Lynch was manager, it fell by 10% fifteen times, 15% six times, 20% four times and 30% once. Each of these drops gave the over-active investor an excuse to bail out, while subsequent recoveries armed them with the confidence to buy back in. Unfortunately, the common pursuit of psychological relief in moments of stress also tends to produce a "sell-low / buy-high" trading pattern, which is ultimately fatal to an investment plan.

Stocks have been on a tear for about 18 months and are undoubtedly due for a pause *(not surprisingly, we've recently fielded several queries on the topic)*. While we're 100% certain that a pullback will occur, we unfortunately have no idea when it will come, how deep it will go, or how long it will last – or even if the potential benefit of trying to avoid it will exceed associated tax and friction costs. In truth, if we were in the habit of trusting our collective gut, instead of sticking to a disciplined process, we probably would have moved to cash a long time ago (we don't feel any better about two hot wars, the recent uptick in inflation, or the hyper polarized political landscape than you do). But markets don't care about our feelings and most of what we might regard as pertinent has almost always been long since digested by stocks. In the next issue of this commentary, we could very well be talking about a quarterly decline for your equity allocation, and it may be more than just a speed bump. History and the well-documented mistakes of others, however, tell us that our best course will be to stay put, regardless of how bleak things might seem in the moment or how tempted we are to try and outsmart the market.