DM PORTFOLIO COMMENTARY
2nd Quarter 2024

Semi-strong

The S&P 500 reached a new high in Q2, but if observers were concerned about the market's breadth of participation three months ago, they should be downright distressed about it now. We said last quarter that it's not our nature to talk about individual stocks in our portfolio commentaries - *and certainly not ones that we don't even own* - but it would be pretty tough to write anything about investing conditions right now without mentioning Nvidia. With the stock accounting for nearly half of the S&P's second quarter return, the "Magnificent Seven" has been abruptly pared down to the "Sensational Single".

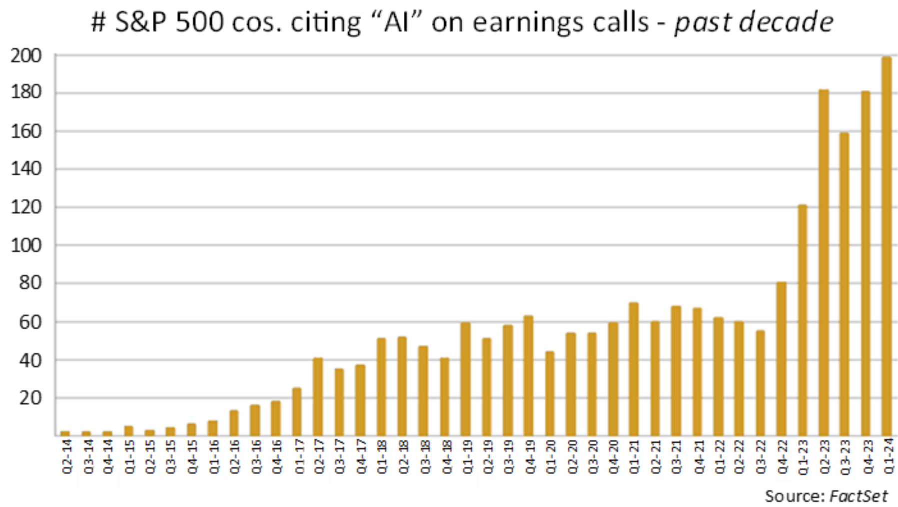
As most readers know, Nvidia makes semiconductors that, amongst other things, power the processors used to design, develop, and train artificial intelligence applications. The company has a notable lead over its competitors and is a primary recipient of the AI-related expenditure being lavished about by tech giants such as Microsoft, Google, Meta, and Amazon. It has the right product at the right time and it's generating a prodigious amount of revenue and income growth. It's this current and projected profitability that has propelled the company's market value from $370 billion at the beginning of 2023 to more than $3 trillion at the end of June. To provide a sense of how big a trillion is, consider this: a million seconds ago it was 11 days before now; a billion seconds ago it was 1993; and a trillion seconds ago it was roughly 30,000 BC, or about 24,000 years before the earliest civilizations began to take shape.

So does Nvidia's new heft mean that it's set for a fall? Not necessarily. As per above, it's the dominant company in the hottest sector and, for the moment, corporate budgets for AI spending seem to be without bound. The stock's performance from here, however, could be blunted by a few factors. First, as the preceding illustration implies, Nvidia may soon face the limiting effect imposed by very large numbers, not only in terms of its value but also with respect to its expected growth. In each of the past ten years, for example, Walmart has been the largest US company in terms of revenue, with its annual sales equal to just over 2% of American GDP. Though Nvidia's revenue is much smaller today, if it were to keep growing at the rate that analysts are forecasting for the coming three to four years, it would pass Walmart in 2031 and in a decade, it would reach a scale equivalent to more than 6% of total US output (assuming that GDP grows at a constant 3%).

While this isn't an apples-to-apples comparison because Walmart is almost entirely US-centric and Nvidia can sell its wares around the globe, it nonetheless provides a sense of how challenging it can be for a massive company to maintain a breakneck pace of growth. To be clear, not even the most bullish analyst is predicting that Nvidia will keep growing at its present rate indefinitely, with most modelling a marked slowdown coming in the 2026-27 timeframe. This means, however, that at some point in the relatively near future investors will have to reassess the stock's outlook and valuation against a necessarily tempered set of metrics and expectations, and it's not difficult

to imagine that their willingness to bid up Nvidia's share price will be likewise curbed as this moment comes into sight.

As mentioned, the buzz around artificial intelligence is seemingly everywhere right now and almost every company wants to show investors that it has a plan to take advantage. This is reflected in the accompanying chart, which displays the frequency of AI mentions in S&P 500 quarterly earnings calls over the past decade; as you can see, the topic has spiked in the past year and we can only imagine how frequently it will come up when managers review second quarter results in the weeks to come.



Even though most corporate leaders are disciplined strategists, they aren't always impervious to the tide of popular opinion. Remember blockchain? References to that technology jumped to 235 in Q4-21 earnings calls, but had plunged by 80% as of the end of 2023. How about the metaverse? Facebook was once so convinced that it went as far as changing its company name and, though it's since buried its multi-billion dollar detour and reoriented itself toward AI, it's unfortunately stuck with the Meta moniker. And it's not just big companies that are clamouring for a share of the AI glow and marketing caché:

- Oral B is now selling a $400 toothbrush that employs AI to provide "personalized live coaching" (hopefully golf clubs will be soon to follow);
- New parents can splurge for the Glüxkind Ella stroller which uses AI to steer itself around (we're not quite ready for self-driving cars, but prams for infants? Let's go!);
- Or how about the DeRucci T11 Pro pillow, which contains "patented AI technology" to stop snoring? (we may have just completed this year's Christmas shopping list for long-suffering wives reading this letter).

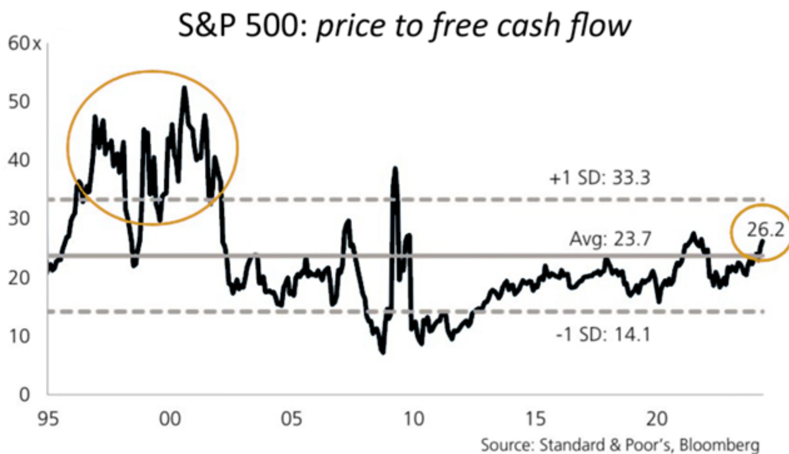
So yes, artificial intelligence will undoubtedly change our lives and the economy in ways that we can't yet fathom, just as the internet and cellphone have done over the past couple of decades. *By virtually all accounts, it's going to be one of history's most impactful innovations.* But the line from here to there is unlikely to be a straight one and it's starting to feel like the story might be running a bit ahead of itself. And, almost assuredly, some of the early capital deployed in the space will either be spent paving roads to nowhere, or worse, to satisfy shareholder demands ahead of investment fundamentals.

Speaking of capital investment, it's impossible to know how much of the hardware being bought today is for immediate use and how much is being stockpiled, both to ensure that equipment will be available for future needs and potentially to keep it out of the hands of determined competitors. Given the very nascent stage of the technology, though, it wouldn't be unreasonable for implementors to pause for a beat to digest what they've acquired so far, to fine-tune existing

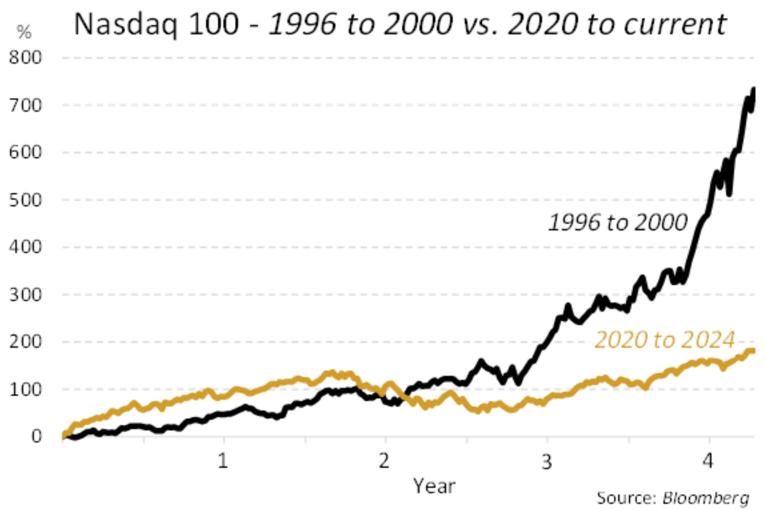
projects, or to verify that whatever path they've chosen is in fact the optimal one. Though this wouldn't represent an enduring threat to the businesses of chipmakers and other equipment suppliers, it would undoubtedly trigger a reevaluation of the assumptions that have helped to drive their shares to celestial heights.

Would a slowdown in Nvidia threaten the rest of the market?

There's been no shortage of commentary comparing the current ebullience in the tech sector to the NASDAQ bubble that inflated (and popped) just over two decades ago, including a frequently shared chart which superimposes the stratospheric rise (and subsequent fall) of Cisco Systems on top of today's surge in Nvidia. That specific analogy is flawed, however, based on the vast difference in profitability between the current index leader and its erstwhile peer, which is also true of the market in general. The chart below shows the S&P's price to free cash flow ratio dating back to mid-1990's and, as you can see, we're nowhere close to the valuations that characterized the halcyon days of the dot-com era.



Even on a straight price basis, the tech-heavy NASDAQ 100's rise from the covid-market bottom to the end of Q2-2024 isn't even in the same galaxy as the early 2000's rocket shot:



For these reasons, and because aggregate earnings continue to be supportive of share prices, we're not overly concerned that a pullback in Nvidia would have a significant knock-on effect for the rest of the market, despite the stock's oversized contribution to recent performance.

As it happens, on the first day of trading in the new quarter, each of Apple, Amazon, Microsoft, and JP Morgan made new all-time highs, while Alphabet took an extra day to reach that mark. Of course, four of these names are prime culprits in the "breadth is too narrow" narrative and now account for 28% of the NASDAQ Index. At the same time, however, they also possess some of the strongest balance sheets in the world; generate prodigious amounts of free cash flow; own some of the most valuable and recognized global brands; enjoy high levels of pricing power and operating leverage; and operate in industries with relatively low regulatory burdens. Given all of that, the right question might be, "Why *shouldn't* they account for a dominant share of market value?"

What about Canada?

Canada lagged the US in the second quarter, both economically and in terms of equity market performance. The former setback spurred ours to be the first major central bank to cut policy in-

terest rates, while the latter one was reflected in a three-month loss for the TSX. DM Canadian equity mandates significantly outperformed the market in Q2 and over the past 12 months, however, helped in part by takeover bids made for four of our positions. The average premium on these transactions was 58%, which provided a welcome boost against an otherwise lacklustre investing backdrop.

Though it's easy to be down on Canada at the moment, we've found no shortage of opportunities in the domestic market, where relative valuation is attractive. We continue to target niche names which can thrive in spite of economic headwinds and have already redeployed some of the capital flowing from the aforementioned takeovers into new positions, or to boost allocations in favoured existing holdings. In the second half of 2024, we'll continue our search for ways to incrementally improve all DM mandates from both a risk and potential return perspective.

Happy summer everyone – stay cool out there!