Pavlic Investment Advisors

Client Review & Outlook

2nd Quarter, 2023

Dear Client,

The second quarter of 2023 was yet another strong quarter for our strategies at Pavlic Investment Advisors, marking the third consecutive positive quarter for our portfolios as the market continues to bounce off of its October 12th, 2022 low. As of that date, last fall, we had been in a bear market for 282 days and the market was 25.4% below its peak that was reached on January 3rd, 2022. Since the October, 2022 low, the market (as well as our core portfolio of stocks) has recovered more than half of the losses incurred in from January, 2022 – October, 2022, and we remain about 10% from new all-time highs. Where do we go from here? We are maintaining our balanced strategy of investing in a sector-neutral manner with a blend of the highest quality growth and value stocks in combination with our ~5.0% average weight in the money market fund earning ~4.9% in interest today as our "rainy day fund". With the money market fund allocation, we are being paid to wait for any "opportunities" that may lie ahead, while letting our existing holdings run.

Equity Style Snapshot			6/29/23
YTD	Value	Blend	Growth
Large	1.6%	15.9%	31.3%
Mid	2.5%	7.7%	13.8%
Small	4.9%	8.5%	13.8%

PIA Portfolio

We entered the year with an almost unanimous consensus amongst financial pundits that we would enter a recession in the first half of 2023. However, the proverbial "can" has been kicked down the road again. The market has proved resilient through continued geopolitical turmoil, additional Fed rate hikes, large bank failures, and inflation that remains high despite its downward trajectory. You'll often hear us say "the second derivative matters most." Also called the rate of change of the rate of change, the second derivative of inflation has seen an acceleration to the downside over the past several months. We are also a big believer that stock prices, over the long term, follow earnings (cash flows) of the companies that generate them. Earnings for stocks in the S&P 500 Index declined just 2.2% YoY vs. an expectation of -6.7%, per FactSet. In fact, companies have beaten earnings expectations by an average of 7% in the most recently reported quarter. Revenue growth is +3.9% YoY with net profit margins of 11.5%, an increase of 0.2%. This increase in margins signals both efficiency and productivity gains. Earnings have held up well, which has stifled the bear case.

The final nail in the coffin, for the bears year-to-date has been investor sentiment. There are a few different types of metrics that track investor sentiment. One of the most widely used is the AAII bulls/bears spread. Back in October of 2022, readings were as low as -40% signifying many more bears than bulls. Today, we stand at +15%--a positive, albeit hesitant, bull ratio. Keep in mind this is a contrarian indicator: the more negative the number, the more positive it has been for future stocks returns. Said another way, the worse you feel, the better time it is to buy stocks (and this is what makes investing hard). Looking forward, investors are marginally confident, which means sentiment is no longer a tailwind for this market. The "pain trade" is not higher anymore-we are thinking about this as we continue to position portfolios for long-term success.

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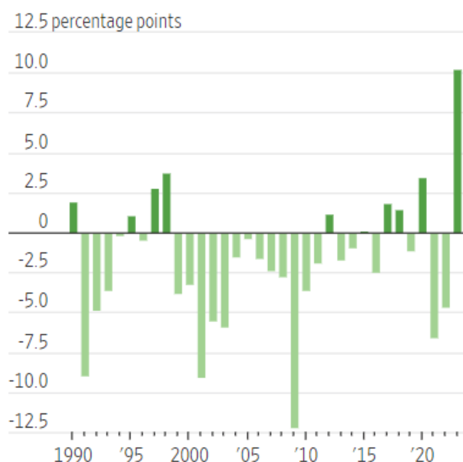
Stock Market Review

We focus our stock market review on the most common questions we have been asked during the previous quarter. Client questions have focused on artificial intelligence, recent portfolio adjustments, and market observations we have around market breadth (or lack thereof).

Narrow market breadth—both a good thing and a bad thing. Market breadth is a measure of how wide the dispersion is between the stock winners and the losers. A healthy market is a market in which most, if not all, sectors, styles, and market caps are adding to the overall market's strength. Market breadth in the first six months of the year has been very narrow, meaning just a handful of stocks have driven the vast majority of the returns at the broad market level. In fact, as of the end of the quarter, seven stocks (AAPL, MSFT, TSLA, GOOGL, NVDA, META and AMZN) have accounted for more than 90% of the YTD returns in the S&P 500. Said differently, if we exclude these seven stocks from the S&P 500, the index would be up only ~3% for the year! To examine this more closely, the chart at left shows the S&P 500's performance vs. the S&P 500 equal-weighted index. Historically, the bars have been negative, meaning the equal-weight index has outperformed the market-cap weighted S&P 500. This makes sense because smaller (riskier) stocks perform better than large (less risky) stocks. However, lately, the largest gains have been in the largest stocks, i.e., the S&P 500 market cap weighted index has outperformed by over 10% so far this year--something we haven't witnessed since at least 1990 (the entire history shown on this chart).



Note: Figures are through June 5 of each year.
Source: Dow Jones Market Data

This begs the question "is this a good thing or a bad thing" and our short answer is "Both". To start, our clients have been big beneficiaries from the rise by the "Magnificent Seven" as they are being called today. Our two biggest weights in our stock portfolios remain **Apple (AAPL)** and **Microsoft (MSFT)**, which are up 45% and 40% in the first six months of the year, respectively. Our long-time clients have held these positions for years, if not decades. Although we don't own chipmaker Nvidia, due to high valuation concerns, in August of last year we purchased a much better valued semi-conductor company, **Applied Materials (AMAT)**. In the last six months, AMAT is up over 50% and is closer to its intrinsic value, i.e. a better value, than Nvidia. Although we haven't owned all seven of the "Magnificent Seven", we are very happy with those that we do own and all have been additive to our performance.

So why is narrow market breadth also a bad thing? The other 80% of our portfolio's performance has been up only in the low-mid single digits on average. As shown in the style box on the first page, value and small cap stocks have materially lagged the broader markets. Sectors such as financials, health care, utilities, and energy are actually down for the year as technology, communication services, and consumer discretionary (led by Amazon and Tesla) have catapulted market returns. As such, we are contrarians by nature and find the best opportunities at present within the biggest lagging subsectors (right), while maintaining our highest sector concentration within technology.

Sector Snapshot	6/29/23
Sector	YTD Return
Technology	38.12%
Comm. Services	34.84%
Consumer Cyclical	30.48%
Industrials	9.23%
Materials	6.67%
Real Estate	3.25%
Consumer Defensive	-0.19%
Financials	-1.36%
Health Care	-2.52%
Energy	-6.01%
Utilities	-6.78%

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Narrow market breadth is great when you own what is working and difficult if you don't. We look to what hasn't worked–value stocks, small caps, and sectors such as energy, utilities, health care, and financials-for the best opportunities looking forward. This quarter has been a good reminder that we are well diversified because we have areas of the portfolio that haven't performed well. We are believers that you are not properly diversified unless there is some part of your portfolio acting as a thorn in your side. Diversification sounds great, but in practice is difficult because you must accept that something in your portfolio is going to underperform at any given time. **Diversification is about giving up on the ability to hit a grand slam, so you don't strike out at the plate.**

Portfolio positioning includes trimming high multiple stocks with a focus on keeping capital gains low. During the quarter, we trimmed our ~4.0% **McDonalds (MCD)** position down to ~2.5%. We also trimmed our ~4.5% **Stryker (SYK)** weighting down to 3.0%. This is not because these companies are not operating on all cylinders—quite the contrary—they are operating at an extremely strong level with double digit growth on both the revenue and earnings per share line items. As a result, both stocks traded up to all-time highs, and valuations (near 30.0x earnings for both companies) made us feel that it would be prudent to take some chips off the table. Simply put, these stocks have been terrific investments and we see better opportunities elsewhere in the marketplace. We continue to view both McDonalds and Stryker as best-in-class in their respective industries, and we would not be surprised if we increased our weighting in these stocks if they have better valuations in the future. When money market funds can offer our investors ~5.0% virtually risk free compared to a stock at over 30.0x earnings (the inverse of which equates to an earnings yield of 3.3%) we see the risk reward balance shift in favor of conservatism.

Artificial Intelligence. AI. AI. AI. Artificial intelligence was the most prolific topic of conversation this quarter and put the inflation discussion on the back burner for the time being. When someone brings up "artificial intelligence", the product that comes to most investor's mind is "ChatGPT". ChatGPT is owned by **Microsoft (MSFT),** our largest holding. This has driven MSFT shares to new all-time highs. Google has a competing product called "Bard", but having tested both, we do find it interesting that ChatGPT has a much better name recognition than "Bard". Secondly, greater computing power means continuous investment in semiconductor chips. Currently, it is estimated that Nvidia (NVDA) controls over 90% of the chips needed to execute AI related tasks today. This has propelled the stock to astronomical valuation levels. While we don't plan on buying Nvidia anytime soon, given current valuation levels, we are glad we added **Applied Materials (AMAT)** as our semiconductor play last August. Applied Materials creates the equipment and software required to create semiconductor chips. They sell this equipment and software to the semiconductor chip manufacturers, like Nvidia. This allows us to get exposure to the sector, without having to prognosticate on who has/will have the best chips. We believe that in an (AI) gold rush, don't dig for gold; instead, sell the picks and shovels.

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Bond Market Review

Another Fed meeting; another Federal Funds interest rate hike. While the pace of rate hikes has slowed and we are likely nearing the end of the interest rate hiking cycle as the rate of change on inflation has slowed dramatically. It is important to note just where the benchmark Fed Funds rate has landed on an absolute basis. As of June, the Federal Fund interest rate target range is 5.00-5.25%. The federal funds rate is the rate at which commercial banks borrow and lend their excess reserves to each other overnight—essentially the shortest maturity term rate paper you can buy since these "loans" are settled every morning. Being able to lend overnight at a ~5.0% annualized rate allows us, as investors, to earn returns on prime money market funds near ~4.9% (net of the fees charged by the money market fund managers). This is great news. For the first time in well over a decade, savers now have an option to park cash in money market funds and earn almost 5.0%. Money market funds have the advantage of being more liquid than treasury securities with a one-day settlement and no transaction costs to buy and sell. So, why would an investor want to buy investment grade bonds when money market funds earn near 5.0%? The simple answer is "reinvestment rate risk".

Reinvestment rate risk is the risk that you get your money back at maturity (every day is a maturity when you own a money market mutual fund) and the new prevailing market rate, at which you can reinvest, is lower. Today, we can buy high quality investment grade bonds with 5 to 10 years to maturity yielding 5.5% to 6.5%. In addition to the higher absolute yields (~6.5% vs. 4.9%), the real key benefit is that when we purchase an investment grade bond and hold it to maturity, we lock in the ~6.0% income stream until maturity-a date years into the future. Conversely, the money market fund rate changes daily, and we expect this rate of return to decline over the next few years. In the meantime, we will continue to collect our income and look to extend duration, and thus your total return, where appropriate.

2023 Market Outlook and Commentary

This market, as always, has its mix of positives and negatives. Inflation is falling (CPI hit two-year lows recently), economic growth remains resilient, the Fed has paused rate hikes (for now), the debt ceiling debacle came and passed, and geopolitics haven't deteriorated further. These factors combined with higher stock prices have driven investor sentiment back to levels we haven't seen since November 2021, with the bulls outnumbering bears by over 15%. Those that watch market performance closely remember that November 2021 was awfully close to the last all-time high (January 3rd, 2022). As we've mentioned earlier, investor sentiment is a contrarian indicator, and this has us marginally more cautious at current levels. It's counterintuitive, but investors get more excited as prices rise, the opposite of how shoppers behave. People rush to stores on Black Friday to take advantage of discounts, but when stocks are on sale many investors do exactly the opposite—they run for the exits.

We believe the highest value add we provide as money managers isn't always picking the best stocks in the portfolio, but instead keeping our clients focused on their long-term asset allocation policies which often means doing exactly the opposite of what our human emotions tell us to do (lower stock prices = there's no end in sight; higher stock prices = we're going to the moon.). Doing less or doing nothing at all most of the time is the right way forward for the majority of investors.

"Investor emotions of fear, greed, and hope have destroyed more portfolio value than any recession or depression we have ever been through" – James O'Shaughnessy

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