Knightsbridge
WEALTH MANAGEMENT

July 11th, 2024

Summer Quarterly Commentary

"Winter is coming."

House words of the Stark family in HBO's hit series "Game of Thrones"

Loyal readers of the Knightsbridge quarterly commentary will recall hearing a familiar mantra throughout our 1997-1999 letters (available on our website www.knightsb.com): tech stocks are increasingly expensive, it's irrational and defies logic! This might have made for repetitive reading, but it was the correct message each time we wrote it. Those old letters will leave you with some déjà vu regarding how expensive the stock market looks today (even more so given the backdrop of a slowing economy) and our willingness to keep calling this out time and again.

Identifying which areas of the stock market performed well over the last quarter is a straightforward exercise: tech beat non-tech, large companies crushed smaller ones, and expensive growth stocks bested cheap value stocks[1].

[1] Because so many of the world's large-cap tech stocks are American, this means U.S. stocks beat international stocks. More on that later.

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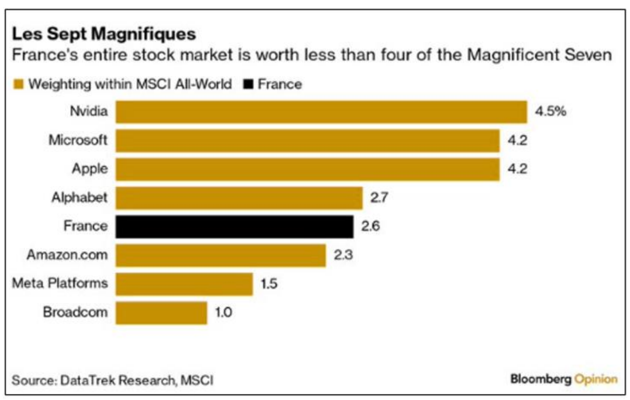
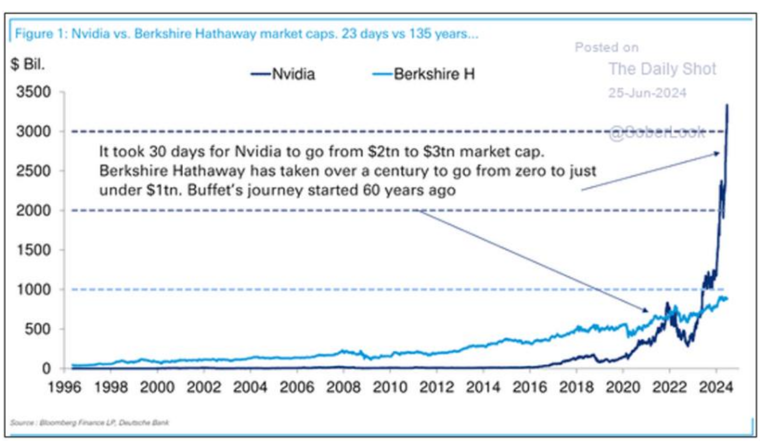
U.S. Stock Market Q2 2024 Returns by Style and Size				
U.S. Equity by Size/Style	MTD (%)	QTD (%)	YTD (%)	1Y (%)
FT Wilshire Large Cap Index℠	3.78	4.40	15.14	26.87
FT Wilshire Large Cap Growth Index℠	7.47	9.67	22.67	38.01
FT Wilshire Large Cap Value Index℠	0.04	(0.80)	7.72	16.23
FT Wilshire Small Cap Index℠	(1.45)	(4.13)	3.53	14.59
FT Wilshire Small Cap Growth Index℠	(0.40)	(3.89)	3.96	13.29
FT Wilshire Small Cap Value Index℠	(2.46)	(4.37)	3.13	15.95
FT Wilshire Micro Cap Index℠	(2.39)	(6.05)	(1.32)	6.15

Source: Wilshire.com

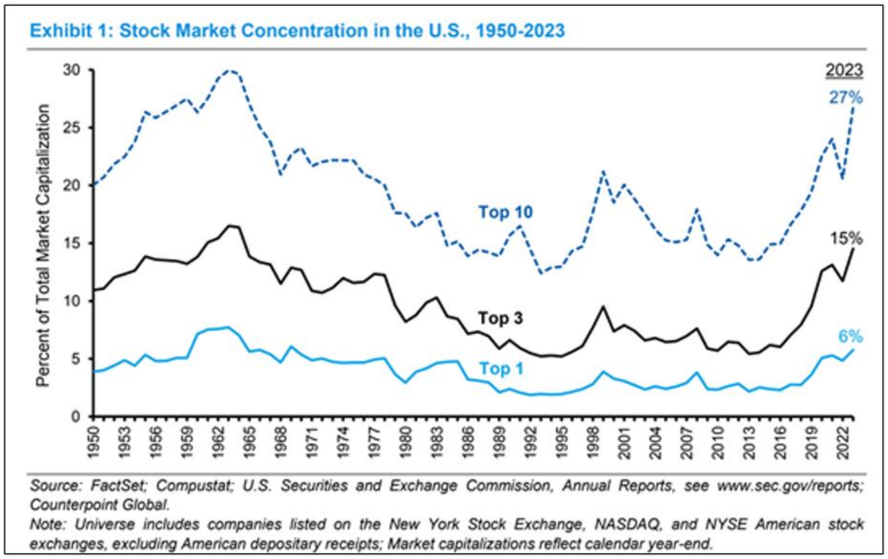
Once again, the market was completely dominated by the so-called Magnificent Seven (Nvidia, Microsoft, Apple, Google/Alphabet, Amazon, Tesla, and Facebook/Meta), as the Artificial Intelligence (AI) boom – or bubble – continues. Four of these companies now boast valuations greater than all of the publicly traded companies in France! Leading the pack this year is Nvidia, the leader in chips that are powering the AI boom. The scale and speed of valuation accretion to this one company is astonishing. Nvidia has nearly tripled this year, at one point adding one trillion (with a "T") to its total market cap in just 30 days.



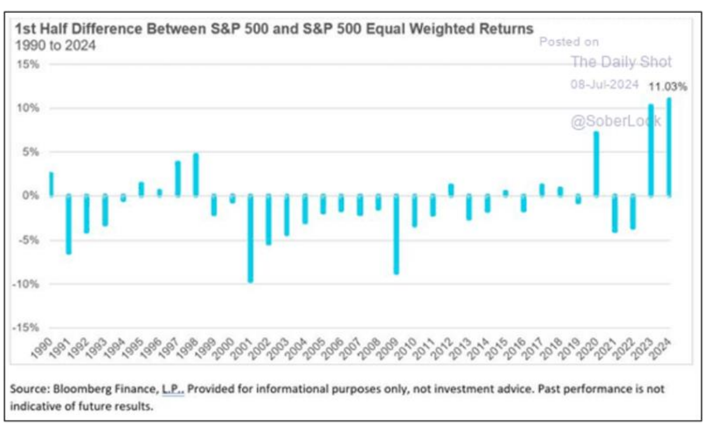


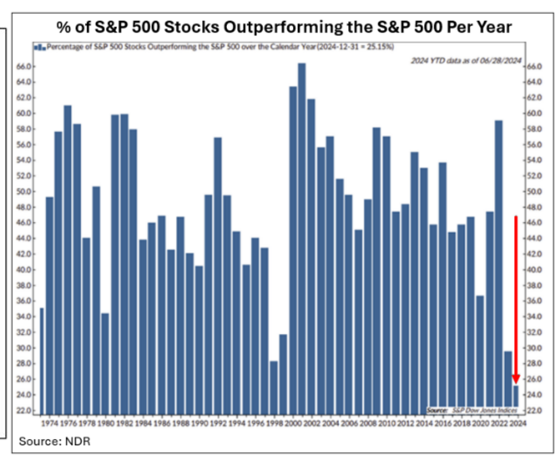
Nvidia and its magnificent brethren Apple and Microsoft now comprise 21% of the value of the S&P 500 Index. You might think that by owning the

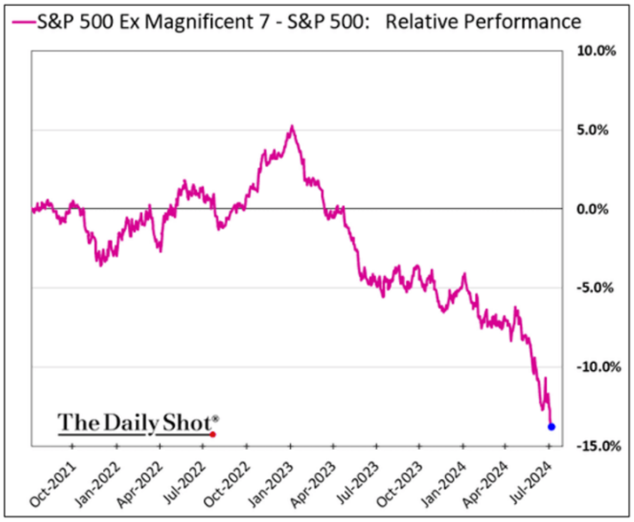
index you are heavily diversified, but in fact the market capitalization-weighted S&P 500 is now more concentrated than most mutual funds. In contrast, the average actively managed mutual fund in the U.S. has only 14% in its top three holdings. Whether looking at the largest one, three, or ten stocks in the index, concentration is at multi-decade highs and has shot past the top-heavy market of the dotcom bubble.

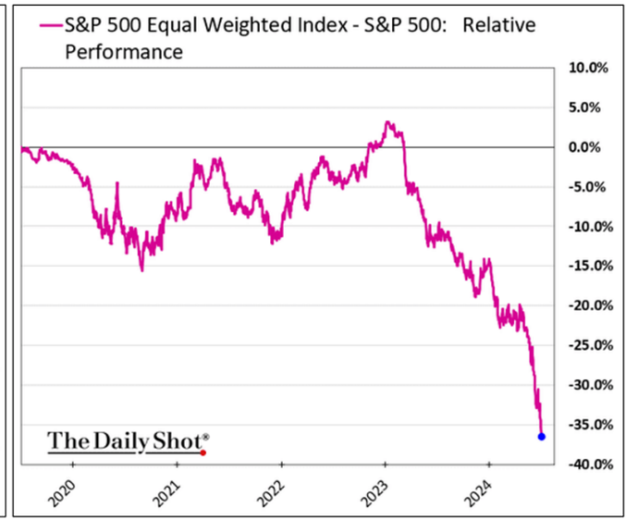


Now governed by a small handful of "mega-cap" stocks, the S&P 500's performance is no longer representative of the "typical" U.S. stock. The average stock today trails behind not only the Magnificent Seven, but the Magnificent Seven-dominated S&P 500. In the first half of the year the S&P 500 Equal-Weighted Index lagged the headline (value-weighted) S&P 500 Index by the most on record. In the last quarter, only 25% of stocks in the index beat the benchmark. To put it practically, typical stocks and the portfolios that own them are swimming against a strong tide.

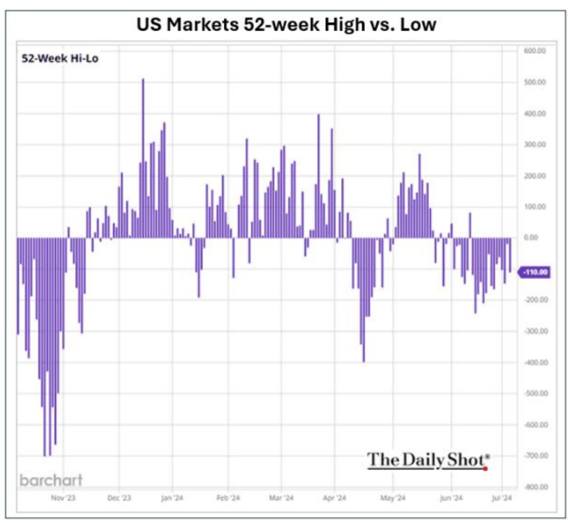








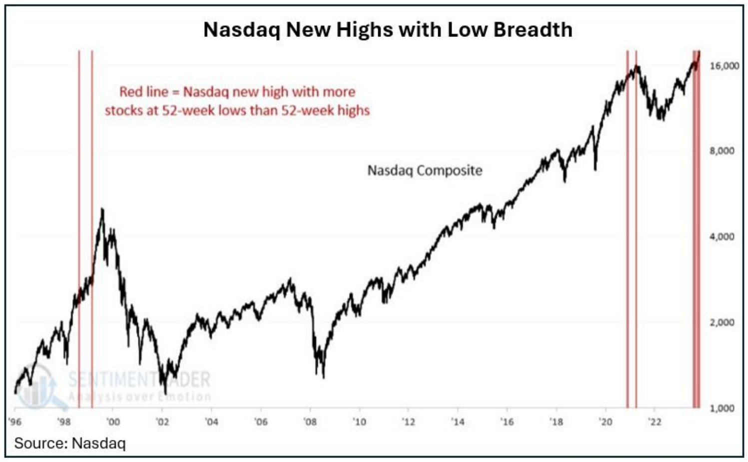
Thus, even while "the market" continues to hit new highs, more stocks are making new 52-week lows than are making new 52-week highs. When the majority of individual stocks are not participating in a rising market, we say that a market rally lacks "breadth". This is typically taken as a sign of an unhealthy, at-risk market.



This "narrow market" has eerie echoes of the dotcom bubble and bust. Three of the last six quarters have seen the equal weighted index *under*perform the headline index by a record amount. Historically, this trend reverses during bear markets. In fact, three of the quarters with the most extreme reversals (equal weighted index *out*performing the headline index) occurred during the dotcom bust[2]. In other words, that historically "narrow" market violently reversed itself in time. While our letters from the late 90's reveal that the tech bubble continued to intensify for several years, when it did reverse, it took the entire market with it. The prospect that we could be in another bubble brings

[2] The other best relative quarter for the equal weighted index was in 2009, during the market panic of the Global Financial Crisis.

to mind a couple of ideas. The first is that such a bubble could continue to grow more extreme for a long time (the tech bubble ballooned for three years, an eternity for a portfolio manager). The second is that the entire market could be at risk.



Since the frenzy around AI seems to be driving much of what we just discussed, let us take a moment to share some of our high-level thoughts on the AI Ecosystem, why some of these companies have appreciated in value so dramatically, and who the ultimate winners might be.

We think the winner of the AI boom is unlikely to be a provider of AI models (the underlying software code). While Chat GPT gets most of the attention, there are numerous other models on the market that perform similarly well. Some are even open source, meaning their design is available for free.

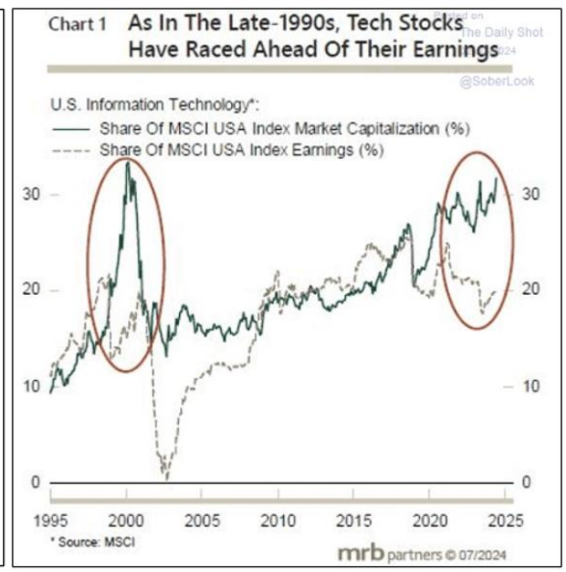
We think AI is less likely to be a standalone product (like Chat GPT) but rather a feature of other, sometimes already existing products. Therefore, perhaps the biggest AI beneficiaries will be those who already provide digital services. If AI improves their services, then we might use them more frequently or be willing to pay more. If Google Search is more precise, you might navigate there more often. If you can ask your smartphone or computer to "please draft a response to this email in my usual style", you might be willing to pay more for that iPhone or Microsoft Office license, both of which seem to cost more every year already. There will likely be many options for the underlying design of an AI model. However, an AI service from Apple or Microsoft might be the only one to offer access to your personal data that will make AI personalized, relevant, and useful.

With the ultimate use-cases for AI still somewhat of a mystery, perhaps the best place to look for winners is not in the providers of AI services themselves, but amongst the players providing the "picks and shovels" of the AI revolution. Nvidia is the most obvious purveyor of metaphorical mining equipment because its AI computer chips are head and shoulders above the competition. If you are running artificial intelligence, you are more or less captive to Nvidia. But can it maintain this dominance?

There is some past evidence to suggest that leading chip companies can maintain their edge. While competitors can and do copy the best technology, advancement is so fast that past leaders have often stayed in front for extended periods.

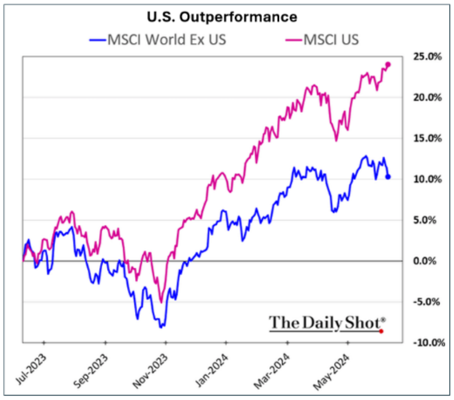
Another place to look for AI "picks and shovels" would be among the so-called "hyperscalers", i.e. the providers of cloud computing. AI currently takes a massive amount of computing power, and this compute is most efficient within the cloud. The main cloud computing providers are, in order: Amazon (AWS), Microsoft (Azure), and Google (Google Cloud). However, these capabilities are not cheaply built. One prominent venture capitalist has estimated that the tech giants are spending $300 billion on AI *per quarter*. Will these leviathans generate enough additional revenue from AI to justify their gargantuan capital spend? Perhaps eventually. But so far, the massive spending spree has yet to yield much additional revenue.

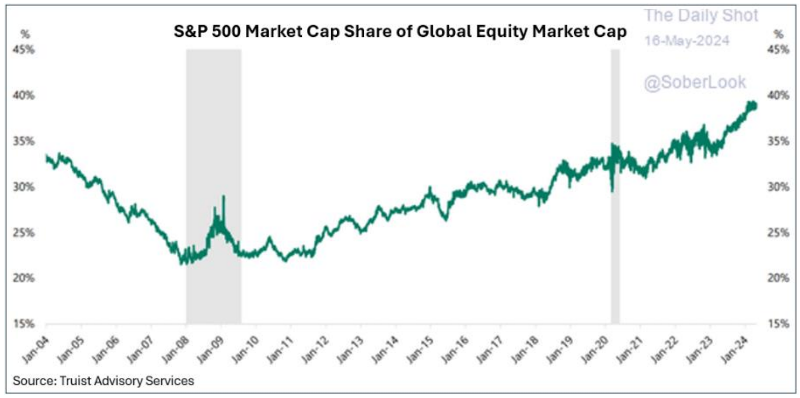
Just like with the internet before it, we believe the promise of AI technology is real. However, rising costs, minimal additional AI revenue, and increasing stock prices have combined to make tech stocks more expensive relative to their earnings and cash flows. This leaves them, and the market, vulnerable.



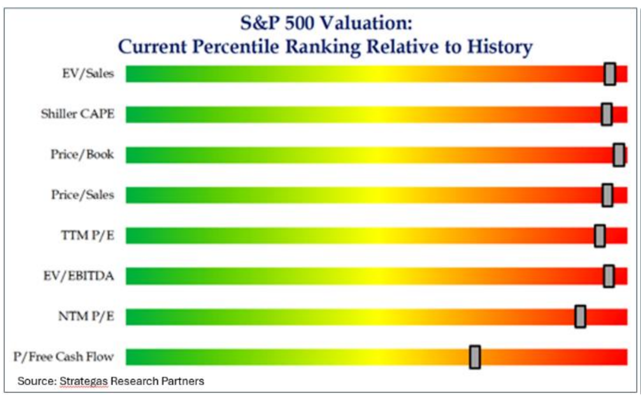
If the other Magnificent Seven (sans Nvidida) fail to show increasing revenue from AI, their stock prices will naturally suffer. They will also likely then reduce their extreme rate of AI spend, which will directly hit Nvidia's revenue. Because the market is now so concentrated, this would have a significant impact on the market as a whole. While our active strategy currently only owns one or two of the Magnificent Seven and has benefitted from some other AI stocks, for now we are mostly watching from the sidelines.

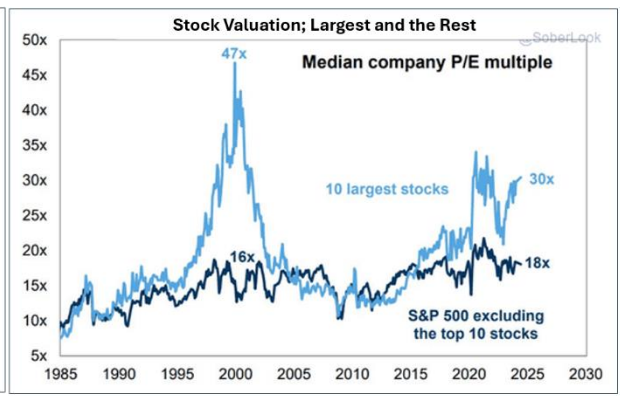
The AI-fueled growth of U.S. tech firms has propelled the U.S. market to continue its long run of besting foreign stock markets. Anyone (in our mind prudently) diversifying away from American shores has been punished for doing so.





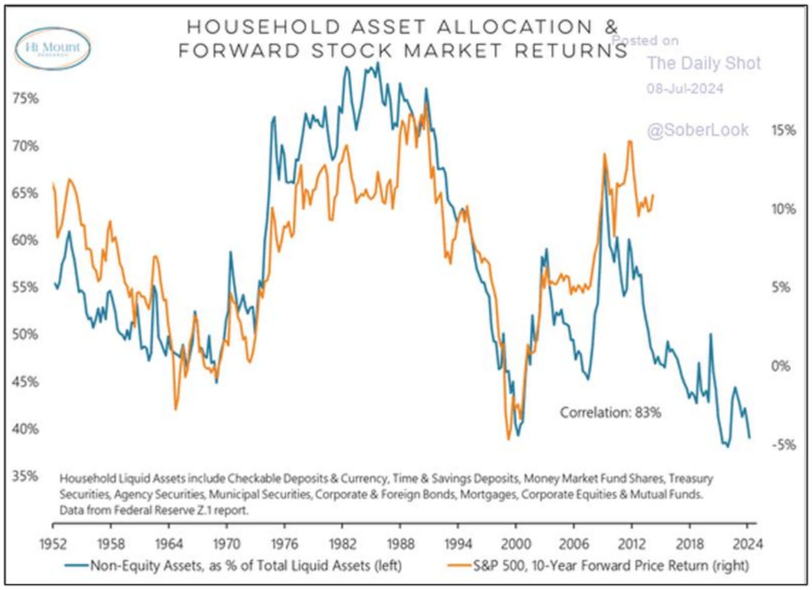
Increasing tech valuations have contributed to the U.S. stock market being extremely expensive when compared not only to foreign markets, but also to itself. The first chart below shows how expensive today's U.S. market is compared to its history. However, the second chart shows this is not the entire story. Unfortunately, the rest of the stock market beyond the top ten holdings is also historically expensive[3].



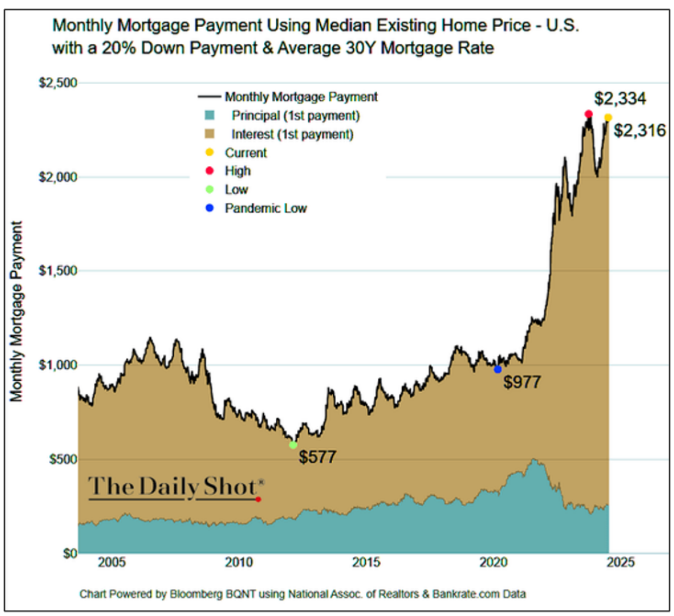


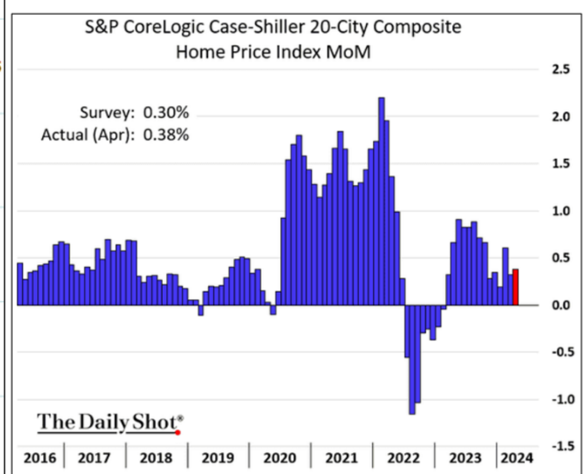
We would also note that investor allocation to stocks is at a major high. This valuation measure (shown below) has demonstrated an excellent correlation to *future* ten-year stock market returns. The current reading indicates very lackluster prospects for the next decade. While we would rarely recommend being completely out of the stock market (and in-and-out market timing is next to impossible) we do believe today's stock valuations increase the importance of diversifying assets overseas and into non-correlated assets like private real estate loans and California Carbon Allowances, which we have done for many of you.

[3] For what it is worth, our flagship equity strategy is invested in companies that are much less expensive than the general market. The forward price to earnings ratio for the S&P 500 is 23 versus around 13 for our portfolio.



Stocks aren't the only asset that could be at risk of a correction. Housing is also very expensive, especially when mortgage rates are taken into account. Despite this, much like stocks, homes continue to go from expensive to more expensive[4].

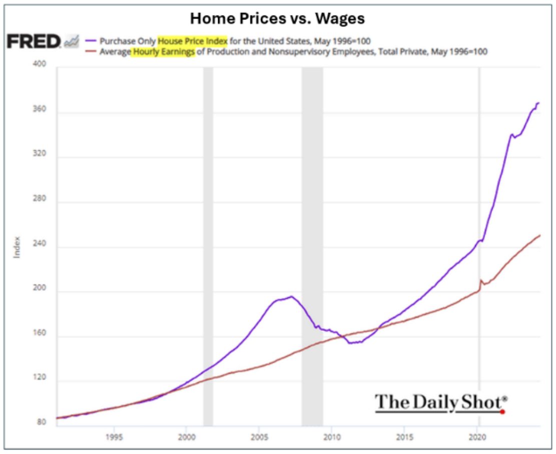


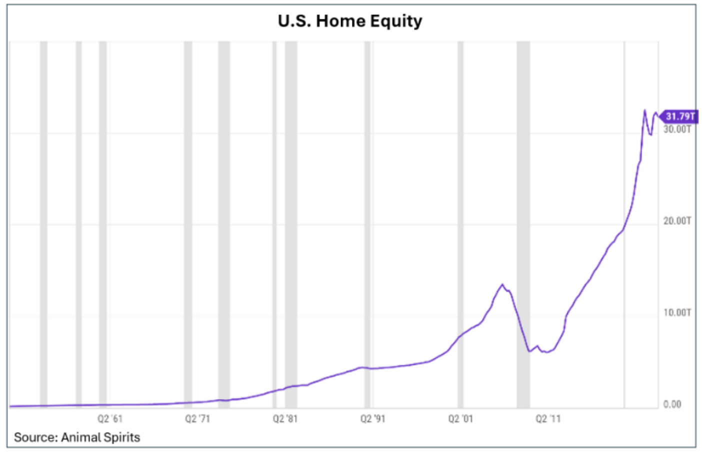


This is less surprising when you think about the cost of housing per square foot rather than per home. The rise of remote work brought on by the pandemic has meaningfully increased demand for housing square footage as buyers now want space for home offices. Even so, rising home prices have driven the gap between home prices and wages further apart than the

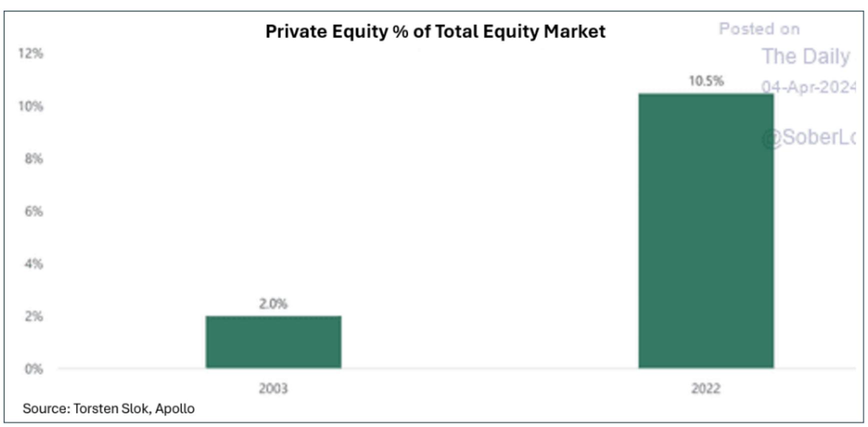
[4] Home price appreciation has continued to play a large role in stubborn inflation.

mid-2000's housing bubble (see chart, below). A pullback would threaten the large amount of home equity accumulated in recent years.





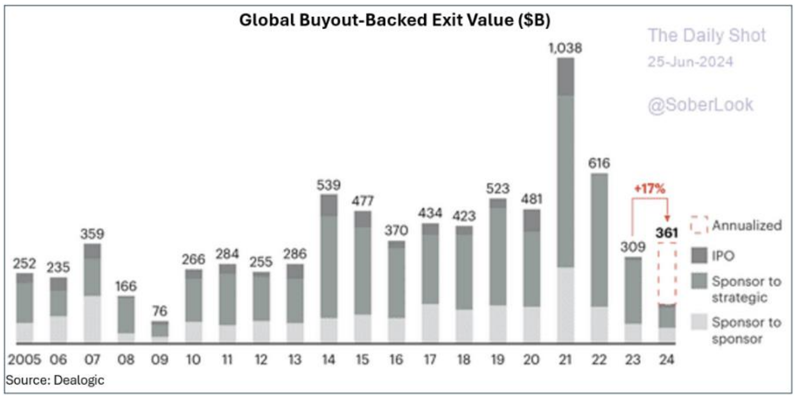
While housing and U.S. stocks are expensive, we still prefer them to certain "alternative assets" that have gained in popularity. Private equity (PE), in particular, (where fund managers borrow heavily to buy private companies) has exploded in popularity since the turn of the millennium. This has only accelerated recently as new innovations have made it much easier for the average household to invest in this space. Yet, despite the increased accessibility, we continue to avoid this asset class for our clients.

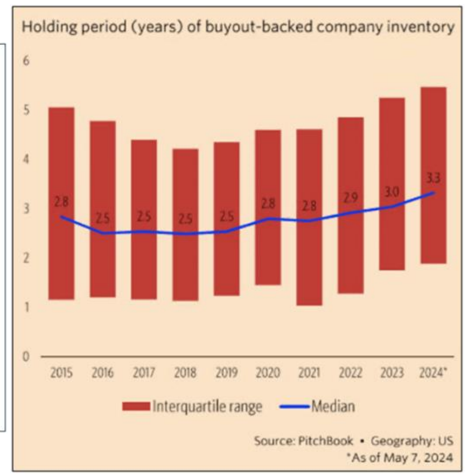


The private equity industry likes to advertise their (supposedly) excellent returns over the last decade. We, however, see reasons for caution.

Firstly, the PE industry's increased size means there is now much greater competition among buyers of private companies, and valuations have risen accordingly. Buying private companies at six times EBITDA is a much better proposition than buying companies at 15 times EBITDA[5]. Investors cannot go back in time and invest in PE's historical track record; they can only invest today and capture the forthcoming decade's results.

And we do mean decade – that's how long a PE investment is likely to be locked up. Because the typical PE company is heavily indebted, today's higher interest rates translate to higher debt burdens and lower profits. Prospective buyers understand this, and PE managers are therefore having trouble selling their existing companies. As a result, PE "exits" are way down as shown below. Lacking buyers, PE funds are holding onto their investments for longer (also shown below).





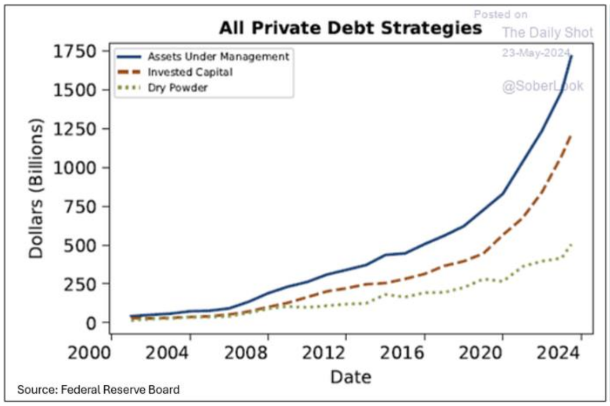
PE managers often have the option to "extend" the life of their funds by a few years. This means PE investors who thought they would be getting their money back after six years are often finding themselves waiting closer to 10 years. So long as the money stays in a fund, the PE manager has wide discretion in setting the value of their investments and is not typically eager to mark them down – that would hurt their reported performance! This is why we stated previously that the PE industry only "supposedly" has good returns over the last decade. PE fund performance is not real until profits are actually distributed. PE investors who do not want to wait around can opt to sell their stake in the secondary market, where they often must accept steep markdowns to find a willing buyer.

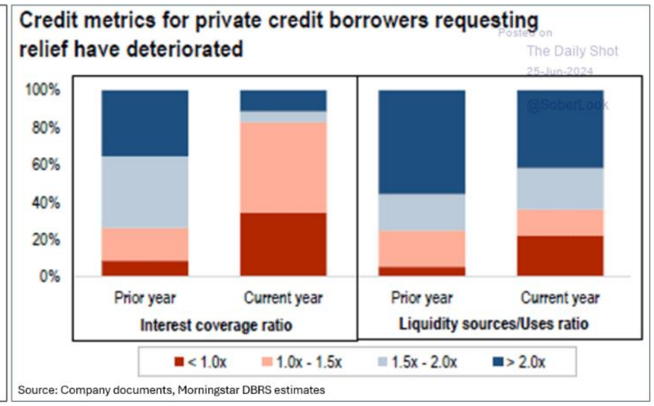
Finally, those attractive PE track records (even ignoring concerns about whether they are "real") took place entirely against a backdrop of falling interest rates. When interest rates fall, asset prices rise. It should be no surprise then that a strategy of using copious debt to buy anything at all looks good in the rearview mirror. Today, we are in an

[5] EBITDA stands for earnings before interest, taxes, depreciation, and amortization.

environment where interest rates are likely to remain elevated and we think such strategies are likely to disappoint going forward[6].

Private credit (where funds lend money to private companies) is another alternative investment that is exploding in popularity and where we see yellow lights. The growth of this asset class has been astronomical. Unsurprisingly, the credit quality of private borrowers has been weakening. Again, the future may not be like the past.



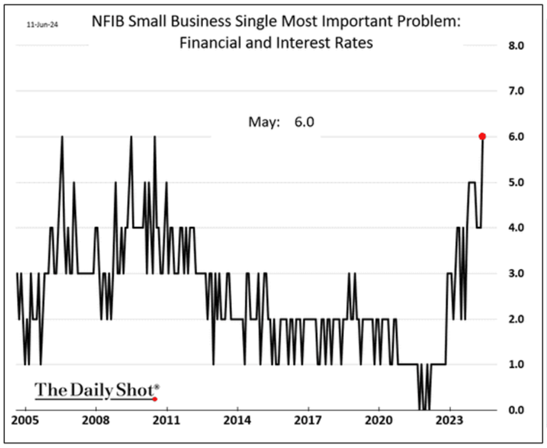


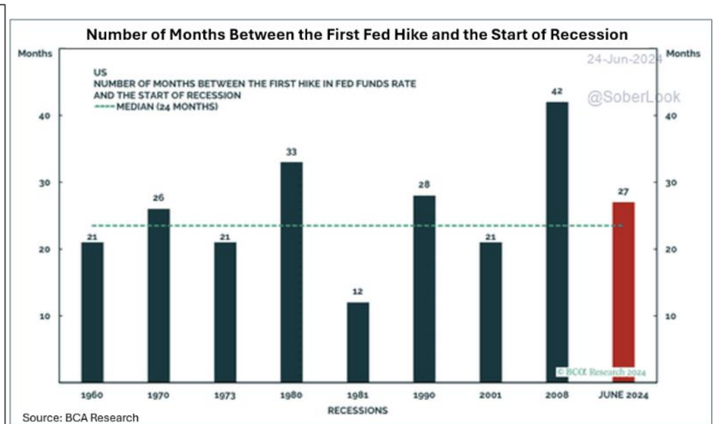
Thus, we see assets as expensive nearly everywhere we look, and all of this is occurring against a backdrop of a weakening economy. And the economy is indeed weakening. Job openings are down and new releases of economic data continue to yield negative surprises.

As discussed in previous letters, the economy has remained remarkably strong in the face of short-term interest rates hovering above five percent. However, higher interest rates are starting do their thing as more small businesses are citing financing as a major issue (see chart

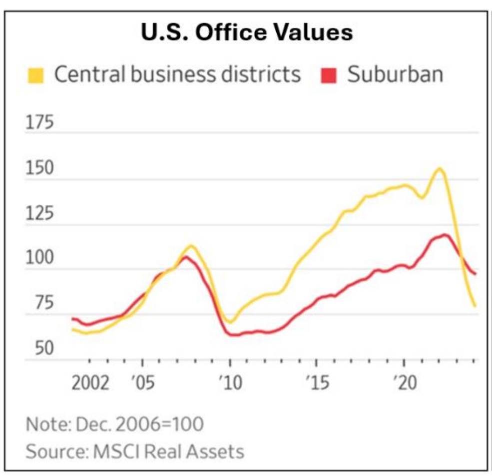
[6] Note the similarity to a "strategy" of using mortgage debt to buy real estate, because such a strategy has produced a lot of gains in the past.

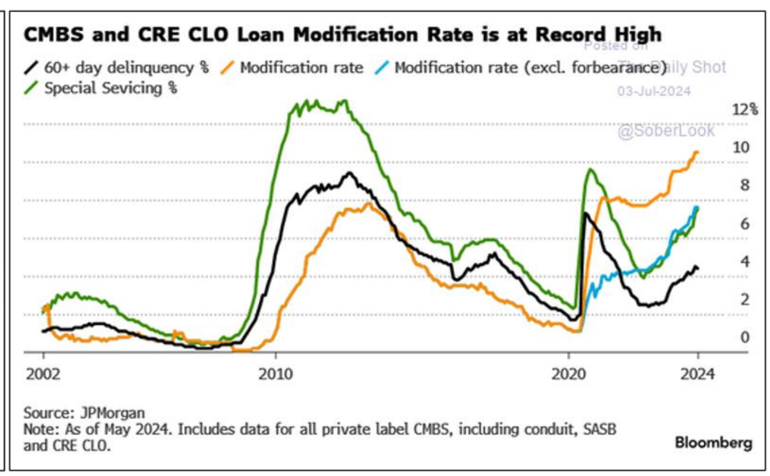
below, left). The effects of monetary policy come with a lag so we shouldn't be surprised that it has taken a while. The second chart below shows that on average it has taken about two years after the start of a fed rate hiking cycle for a recession to begin (it has now been about two and a quarter years).





One area where obviously all is not well is in the office sector, where the combination of rising rates and workers fleeing offices has resulted in declining property values. Moreover, declining fundamentals have resulted in the debt on these properties not being paid back on time. The second chart below shows this in the increasing delinquencies and modifications of Commercial Mortgage-Backed Securities (CMBS) and Commercial Real Estate Collateralized Loan Obligations (CRE CLO).





For now, the economy doesn't look so weak as to rule out a "soft landing", but the risks are probably tipping more towards a slowing economy versus accelerating inflation. Historically, the Fed has only very rarely managed to tame inflation without causing a recession. Again, this economic weakness is all the more concerning against a backdrop of expensive valuations everywhere you look.

We remain, as ever, vigilant as stewards of your hard-earned capital. While we cannot completely avoid market downturns, we strive to mentally and emotionally prepare you for them and do whatever we can to keep your wealth trending in a positive direction. We appreciate the trust you place in us and seek to earn that trust every day.

Sincerely,

John Prichard

John G. Prichard

Miles E. Yourman

Miles E. Yourman

Kurt Beimfohr

Jeff Vieth

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