Summer Doldrums?

I know. I am repeating the same title from my last newsletter. I mentioned the old adage "Sell in May, go away". Well, its not working this summer. Certainly, the Magnificent 7 has had its ups and downs. During the month of July, there was a significant rotation out of technology. But that lasted only a month, and technology had resurged until this week. Small Cap stocks did well, but then showed the same underperformance it has done over the past several years. I have not given up on small caps, as they should benefit from lower interest rates and the eventual adoption of AI. Small Cap stock companies are expected to have healthy profits, better than the S&P 493 (That is, the S&P500 less the magnificent 7).

However, this week, technology stocks have taken it on the chin. In fact, the S&P 500 is heading to be the worst week of the last year. Nvidia lost $250 Billion – that's the market cap of PepsiCo. Nevertheless, the S&P 500 still has gone up 7.40% as of the end of August. So, again, no, do not sell In May, go away.

There is still a fundamental rotation from super growth stocks to other sectors. With lower interest rates, both banking and real estate, both value oriented, have excelled. Nevertheless, over the past month, growth has continued to be king. I am concerned that any bad news in inflation (which is still sticky at around 2.9%, much above the 2% target) and the jobs market can cause some sudden swings. Certainly, recession is a concern. Volatility is certainly not unexpected.

With so much talk about Nvidia, I thought I would talk about their economic or protective moat. What do I mean? We know that the GPU's and data centers are the main bread and butter. It is also #1 in PC gaming with more than 3 times the revenue of the other major GPU vendor. They also power the Nintendo Switch console (for us Pokémon players). But there is not a lot of growth in gaming. Their primary market is data centers. NVidia powers 70% of the world's super computers. Nvidia certainly has a wide moat.

When a company has any characteristics that's hard to replicate, it's considered having a "protective" or economic moat. Warren Buffett, with his investment style, popularized the term "protective moat" where he looks for companies that have significant competitive advantages. Those companies have wide moats. Some characteristics of wide moats are having a huge market share, being a low-cost producer (think Walmart), and having patents, copyrights, or governmental approvals & Licenses (some drug companies, and of course utilities).

A great example of a wide moat stock is Visa. They have such a stranglehold on the network that there isn't really any alternative, except for establishments starting to pass on their cost to consumers, causing more of us to pay cash instead. I bet we all have either a Visa card or a Mastercard. American Express also has a very wide moat. No wonder Warren Buffett owns 21% of the company.

Then we have narrow moats. One that immediately comes to mind is Uber and Lyft. That industry has low barriers to entry and can't really become a low-cost producer. Their competitive moat is very narrow.

But just because a company has a narrow moat doesn't make them a bad buy. Both narrow moat stock Uber and Netflix have outperformed their peers and the market in general. Nevertheless, historically, wide moat stocks have outperformed narrow moat stocks over market cycles.

MOAT ETF is one of the securities that I hold. The parent company, Van Eck, uses Morningstar's Wide Moat methodology to select its securities. It holds relatively few securities (currently 55), holding 1% to 3%, depending on the length of time in the portfolio and other quantitative values. It holds names such as Walt Disney, Biogen, Microsoft, Amazon, Salesforce, as well as Campbell Soup, Adobe, Starbucks, and Etsy. Although Nvidia has a wide moat (remember, it has a tremendous technological advantage as well as a huge market share in supercomputing), MOAT does not hold it.

Its returns have been up and down. The 5- & 10-year return has been excellent, in the top 15% of its peers. And it ranked in the top 5% in 2023 vs. its peers. However, it has had some underperforming years as well (2014, 2015, and 2021), causing a bit higher standard deviation that I would like. This year is no different. While getting off to a bad start in the first several months, its 3-month return lands it in the top 3%. This is mainly due to the rotation out of mega cap stocks into mid and small caps stocks, and higher quality names. Morningstar ranks MOAT with Bronze, 3 stars. They earn their bronze rating from having an above average process, average people, but a below average parent. (VaEck is a privately held firm, founded by Jan van Eck and his family. It has introduced trendy offerings that have not been so stellar). The 3-star rating is earned as a solid performer, but with higher risk associated with their return.

Another holding worth mentioning is the DFA Real Estate Securities mutual fund (DFREX). This real estate fund holds REITs and is considered one of the best funds available to gain exposure to this market. I'm sure I have spoken before regarding REITs, so I will try to keep it simple.

REITs are Real Estate Investment Trusts that holds income-producing real estate. Brought into law in the 1960s, it gives the opportunity for smaller investors to invest in real estate. There are many types of REITs – from office buildings, hotels, apartments, retail, data centers, as well as specialty RE, such as cell towers. In fact, the largest REIT in the U.S. is a cell tower provider. Companies like Iron Mountain (the record keeper) is a REIT.

REITs are good diversifiers. When building a portfolio, you always look at risk. Standard Deviation is a common metric associated with risk. So, when investing, one wants to reduce risk by finding securities that behave independently from each other. In other words, when building a portfolio, you want to lower its standard deviation while increasing its overall return. Bonds have naturally been a good diversifier – they usually don't have a high correlation to equities (as well as bonds generally don't have wild swings). REITs have, by nature, a larger standard deviation. But they are less correlated to the general stock market. Point in case, Real Estate was up this week – even when the rest of the market experienced the worst week this year.

DFA Real Estate (DFREX) earns a Gold rating, with 4-stars. Their process and people are above average, and their Parent (Dimensional Fund Advisors) ranks high. Although it doesn't track an index, it confers the benefits of a traditional passive fund. Their process promotes low turnover and is better diversified than most other REIT funds. It currently holds approximately 98 names.

There seems to be some angst in the market. Everyone has their eyes on slowing earnings and the Federal Reserve. The Fed is expected to lower rates this month. The question is by how much. This angst will pass. It does not appear we will go into a full blown, long recession, if we even have a recession. Nevertheless, I have never been super aggressive in portfolio risk. I tend to look somewhat tactical at times but remember that consistently timing the market is just not possible. I say consistently, because there are many who have been successful – just not time and time again.