SCHAFER | CULLEN
CAPITAL MANAGEMENT

July 6, 2023

James P. Cullen
Chairman & CEO

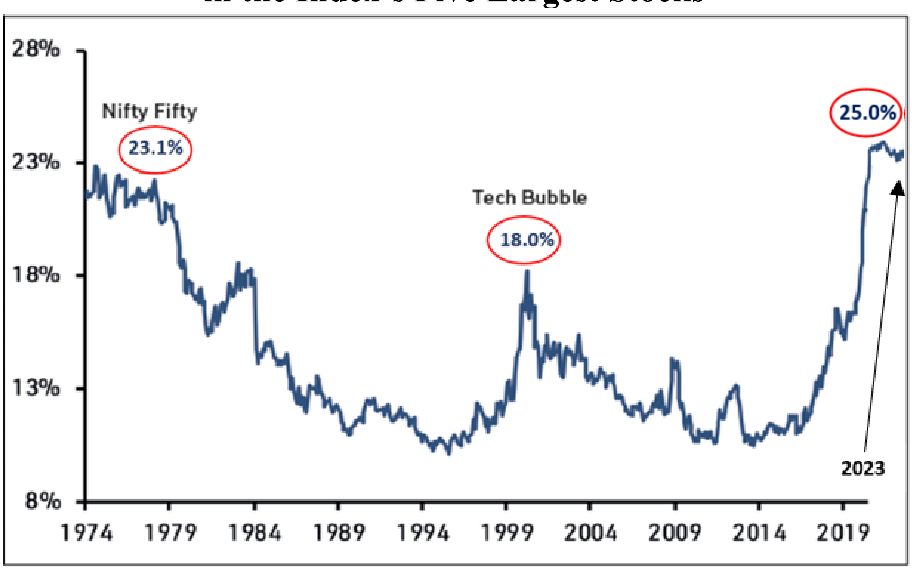
Mid-Year Note

The Danger Zone
Creates
A Time for Value

At the very beginning of the year, we noted how everyone on Wall Street was bearish and expecting a recession. Instead, January of 2023 turned out to be one of the strongest opening months in market history. This powerful move was surprisingly led by short covering whose main beneficiaries were the five popular large cap tech stocks -- Tesla, Apple, Microsoft, NVIDIA and Amazon. Now, six months later, the market mood has changed and the focus has become the huge potential and risk presented by the Artificial Intelligence (AI) stocks. **The main beneficiaries of AI interest are the same five large cap tech stocks, which now represent 25% of the S&P 500.**

This concentration in a few large cap stocks has led us into something which can be called a "Danger Zone", reminiscent of the Tech Bubble of the late 1990s and the Nifty-Fifty Bubble of the early 1970s. History shows that any time a few popular stocks become so dominant in the S&P 500, it has eventually led to a long down period for those stocks. **Below we show that the present concentration is more extreme than both the Tech Bubble and the Nifty Fifty Bubble before it.**

Concentration of S&P 500 Market Cap
in the Index's Five Largest Stocks



SCCM Research, June, 2023

The History of Over-Concentrated Markets

Such markets can persist for a very long time -- remember the 'buy on the dip' mantra of recent bull markets. However, when they finally peak and roll over, the popular stocks have historically underperformed for a long period of time, and because of their heavy weighting in the S&P 500, the once highflyers drag down the whole index, as can be seen in the table below.

	S&P 500	Bottom 20% S&P 500 by P/E
1974	-26.5%	-10.9%
1975	+37.2%	+59.3%
1976	+23.9%	+48.0%
1977	-7.2%	+8.5%
1978	+6.6%	+14.1%
Cumulative	**+23.6%**	**+160.0%**
Annualized	**+4.3%**	**+21.0%**

	S&P 500	Bottom 20% S&P 500 by P/E
2000	-9.1%	+24.2%
2001	-11.9%	+16.2%
2002	-22.1%	-8.9%
2003	+28.7%	+38.6%
2004	+10.9%	+22.3%
Cumulative	**-11.0%**	**+122.9%**
Annualized	**-2.3%**	**+17.4%**

Source: SCCM Research, 2023

Historically what happens is the popular stocks become over-owned, as the current Russell 1000 Growth Index demonstrates. We see that Apple represents 13% of the index, Microsoft is 12%, and Amazon 5%, for a total of 30%. The Russell 1000 is just an index, but most growth investors use it as a benchmark. Investors seeking to outperform the index, have historically had to overweight the popular stocks, and some ETFs will try to get hyper-performance by being double or triple leveraged. This gives you some idea of why momentum investing and chasing performance can feed on itself and run much further than one would expect.

We believe another factor is that the present market is made up of many new investors who don't remember the Tech-Bubble, which was 25 years ago. Similarly, the investors who got caught in the Tech-Bubble, didn't remember the Nifty-Fifty experience, which ironically was 25 years before that.

On a fundamental basis, what traditionally happens to these popular stocks is they reach a point where their growth prospects become limited, and they wind up getting into each other's businesses. This eventually kills margins for all. A present example is Netflix, which once had the streaming market all to itself and now faces competition from Amazon, Disney, Apple, HBO, among others.

Artificial Intelligence (AI)

The present infatuation with Artificial Intelligence (AI) has captured the imagination of investors. **And while AI may be a threat to many businesses, with some not surviving, we can see if we look back over the last 200 years that the financial markets have always had to deal with technological breakthroughs: among them, the electrical power grid, the telephone, the automobile, the radio, TV, and the personal computer.** The market has survived all these innovations and their challenges.

In fact, artificial intelligence is not new, and all of us have been exposed to AI for years, whether we realize it or not. The main example would be Google and their search engine. Also, Apple's *Siri* and Amazon's *Alexa* are examples. Telsa's newest models are also AI based. Fred Hickey of *The High-Tech Strategist* reminded us that Artificial Intelligence was introduced into our lives more than ten years ago when IBM came out with a smart computer called *Watson*. The key feature was its capacity to answer questions. IBM launched a phenomenal advertising campaign for Watson, in which it was placed in the middle of a vineyard and answered questions from the owners about which row of grapes needed more water, which needed fertilizer, which needed to be replaced, and so on. It was a compelling and fascinating advertisement. Whatever happened to Watson?

Conclusion

We believe for long-term investors, the value discipline, especially with a dividend yield, should be very competitive in the present market environment.

If you have any questions, please give us a call.

Jim Cullen

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