PENDLETON STREET
BUSINESS ADVISORS

Pendleton Street Advisors

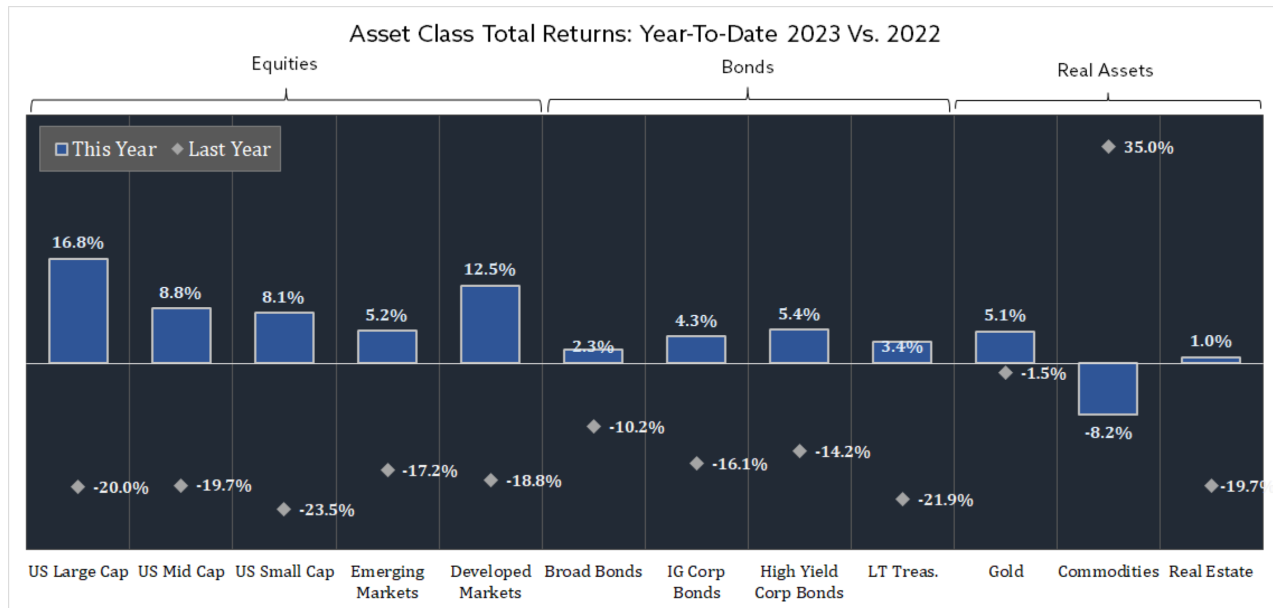
2nd Quarter 2023 Investment Commentary

July 14th, 2023

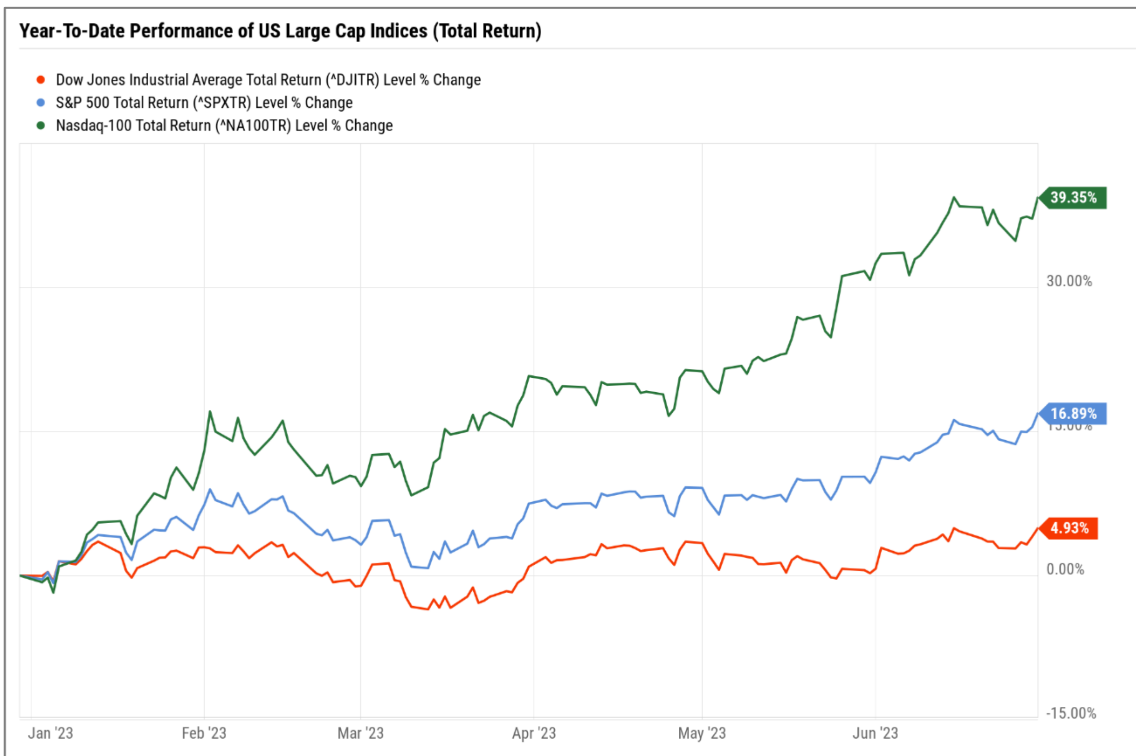
Index Returns	2nd Quarter	Year-To-Date	Trailing Twelve Months
S&P 500 US Large Cap Stock Index	8.7%	16.9%	19.6%
Russell 2000 Small Cap Stock Index	5.2%	8.1%	12.3%
MSCI All Country World Ex-USA Stock Index	2.4%	9.5%	12.7%
Barclays Capital US Aggregate Bond Index	-0.8%	2.1%	-0.9%
US Core Consumer Price Index - (Inflation)	1.2%	2.5%	5.3%

During the second quarter, markets continued a strong recovery that began in the first quarter; with the S&P 500 up almost 17% compared to last year at this time when the index was down by 20%. Bonds are up by a little over 2%, as compared to last year at this time when they were down by over 10%. Client portfolios have benefited from the rise in the overall market, but not as much as we would expect in a broad-based recovery following a down-year like 2022. As we look ahead to the second half of the year, we discuss why client portfolios have not kept pace with benchmarks like the Nasdaq-100 this year, and the rationale behind current portfolio positioning.

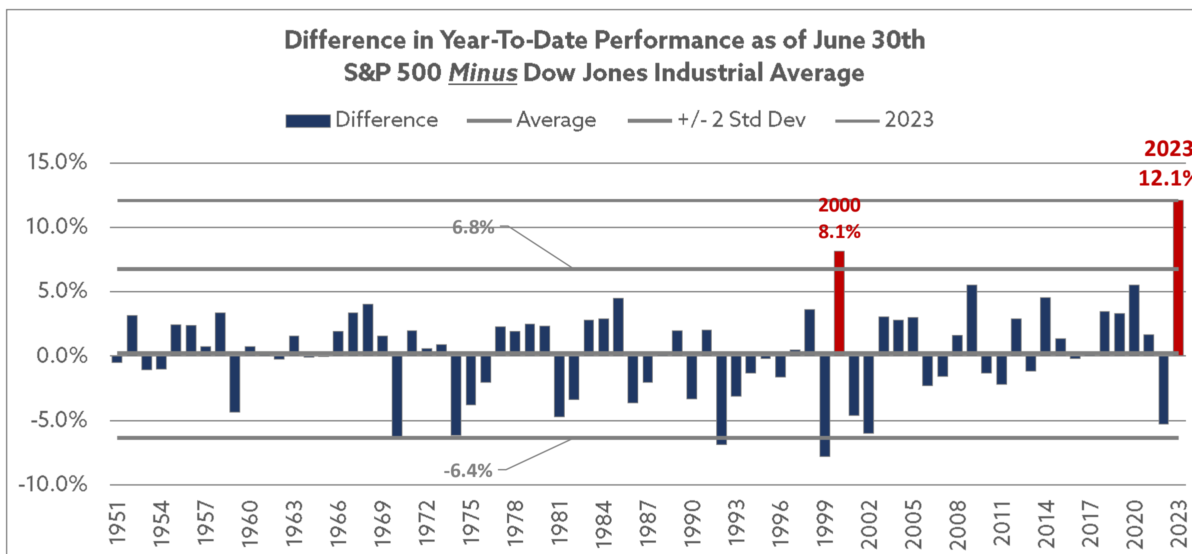
Market Drivers	Indicator Levels As Of...					
	5-Year Average	2020 Year-End	2021 Year-End	2022 Year-End	Most-Recent	Expected in 2023
Inflation (CPI Year-Over-Year %-Change)	3.7%	1.4%	7.0%	6.5%	4.0%	*3.20%*
Source: Bureau of Labor Statistics		*12/31/20*	*12/31/21*	*12/31/22*	***5/31/23***	
Effective Federal Funds Rate	1.56%	0.09%	0.07%	4.33%	5.08%	*5.60%*
Source: Federal Reserve		*12/31/20*	*12/31/21*	*12/31/22*	***6/30/23***	
Actual Real GDP Growth (Yr-Over-Yr-%)	2.22%	-1.52%	5.72%	0.88%	1.80%	*1.00%*
Source: Federal Reserve		*12/31/20*	*12/31/21*	*12/31/22*	***3/31/22***	



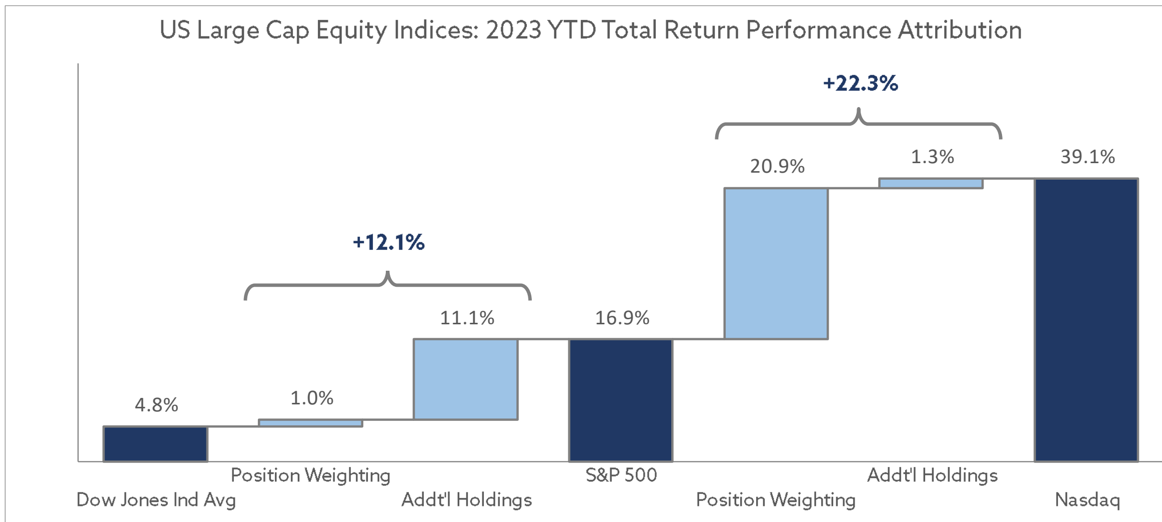
As mentioned above and illustrated in the chart below, equity index performance has been significantly different even amongst highly correlated indices in categories like US Large Cap stocks. The Dow Jones Industrial Average, which includes 30 of the largest US companies, has risen in price by over 12% **less** than the S&P 500. But, that pales in comparison to how much the Dow and the S&P 500 have lagged the technology-focused Nasdaq 100 Index; -35% and -22%, respectively. While the differences seem material, we had two questions to investigate: Is the difference in returns between these indexes really that unusual? And, what is driving the divergence?



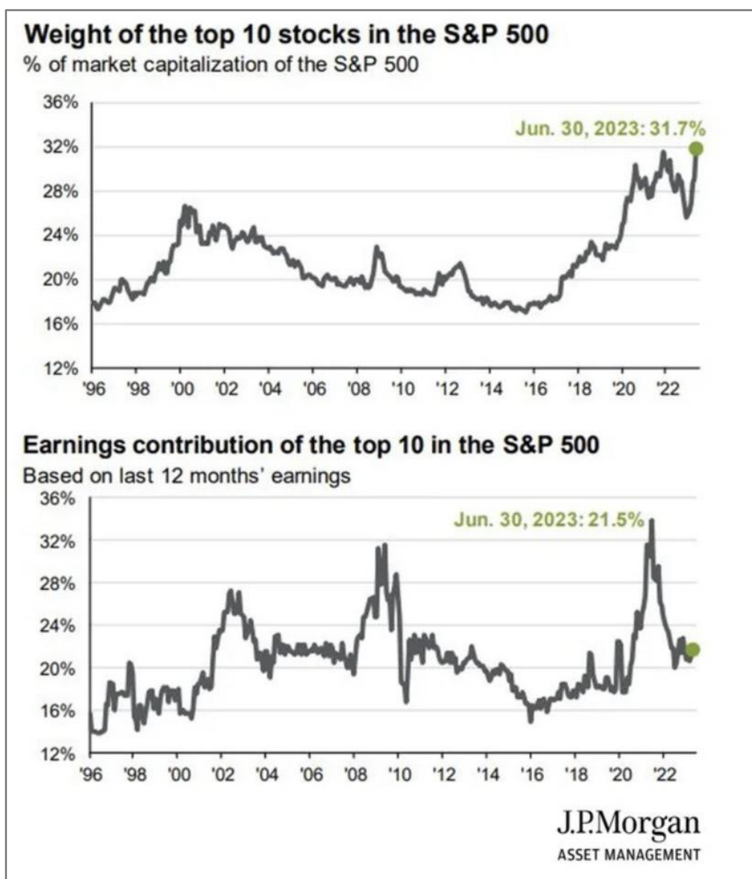
It is clear from our analysis that the difference is unusual. Since 1951, the average difference in first-half returns between the S&P 500 and the Dow has been 0.2%, but it hasn't been unusual for the difference to range +/- 6%. **This year, at 12.1%, the difference is 2 times further from the average than "normal."**



The difference in performance this year between the Dow and the S&P 500 has largely been driven by the S&P's inclusion of 470 additional stocks; while the Nasdaq's outperformance of the S&P 500 has been driven more by differences in position weighting (*i.e. how much of the index each stock represents*). In otherwords: **The S&P 500 has owned what's working so far this year, but the Nasdaq has owned more of it.**



We are not the only ones pointing out the wide disparity in returns, with many others correctly concluding that sentiment on a handful of stocks is driving up index levels that do not reflect the performance of the vast majority of underlying stocks included in them. They also point out, as we did, that the performance of these few stocks may be at odds with their fundamentals. **For example, while the top ten stocks in the S&P 500 represent 31.7% of the total index (a record high going back to 1996), those same stocks only represent 21.5% of index earnings.**



As another example, on July 7th Nasdaq announced that it would carry out a special rebalance "to address overconcentration in the index by redistributing the weights." Both the Nasdaq and S&P 500 are allocated across underlying stocks based on their market capitaliztion (total market value of all shares), and are usually rebalanced quarterly to reflect changes in market cap. For Nasdaq to carry out a special rebalance, the concentration must be concerning to them.

Any professional investor who does not consistently and routinely question what they've been doing and why they've been doing it is not doing their job. But, what can we do with this information? **All three indices are syononymous with "the market" in the minds of the investing public; so, how can they be so widely divergent in performance?** Should investors expect this divergence to continue? **Our answer comes back to a simple framework:**

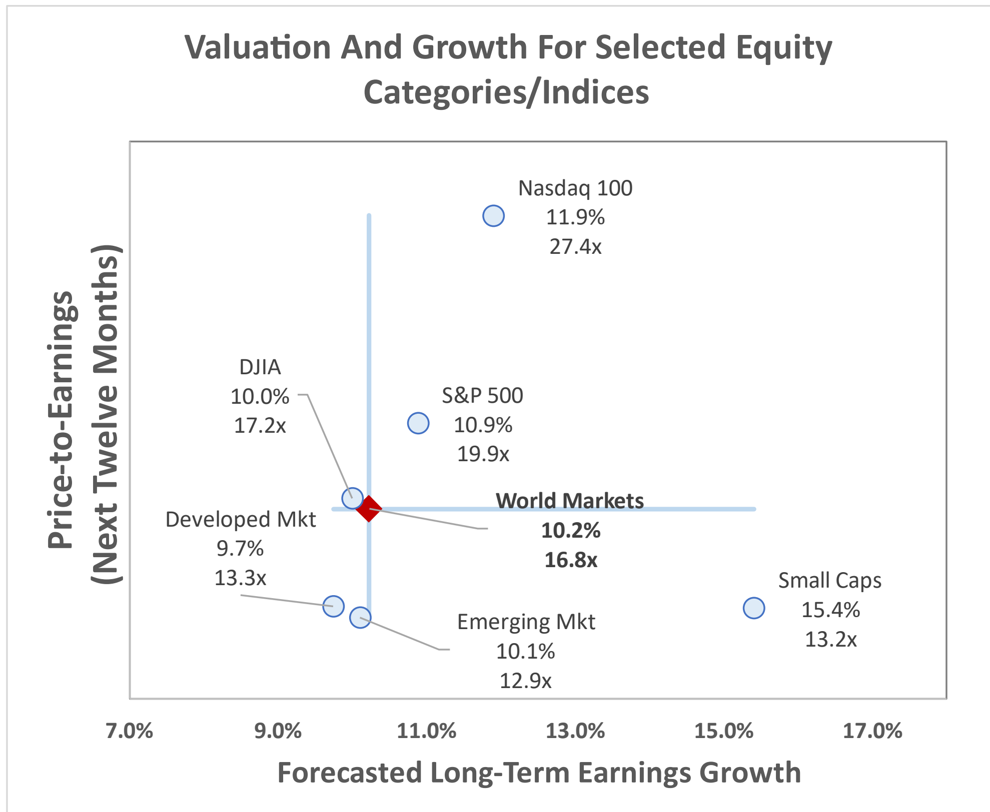
Market behavior over any given time-period is driven by…

- ***Underlying fundamentals (finance), and…***
- ***How people, in aggregate, feel about them going forward (psychology).***

Valuation multiples like the Price-to-Earnings multiple are staples of communication for investors, because they can shed light on how much of an investment's current price is influenced by a) their near-term expected earnings/cash flow, and b) investors' belief - *or lack thereof* – in the underlying company's ability to manage growth and risk.

		When P/E Multiple is…	
		Higher	**Lower**
and Expected Growth is…	**Higher**	Closer to Fair Value	Possibly Undervalued
	Lower	Possibly Overvalued	Closer to Fair Value

We can examine current price-to-earnings multiples and expected growth for individual stocks as well as broader market categories and indices to better understand the risk /return environment (see accompanying chart). For example, while earnings for the Nasdaq 100 are expected to grow by 12% over the next 3-5 years (*vs 10% for the total market*), the index currently trades at 27.4x its next twelve months' earnings (*a **63% premium** to the global market's P/E of 16.8x*). **Two further points:**



1) **We should be asking ourselves if 2% additional growth is worth a 63% price premium over the rest of the market,…**
2) **…especially when Small Caps (using the Russell 2000 Index) trade at a 20% discount to the global market in terms of P/E, and are expected to grow 5% more than the overall market and 3.4% more than the Nasdaq for the next 3-5 years.**

Boiling down our approach to portfolio positioning based on these points, we strive to buy stocks at reasonably - *or unreasonably* - low prices ***relative*** to their current cash flow and expected growth. While we are bound to miss the boat on some stocks that do not fit those criterion, here are a few examples of stocks owned in fully diversified client portfolios since at least the beginning of the year that are not as fun to talk about as Tesla, but are well-run by management on behalf of shareholders; reasonably valued; and have been performing well relative to the overall market:

Ticker	Company Name	Description	YTD Total Return	Price-to-Earnings Ratio
AN	AutoNation Inc	AutoNation is the second largest automotive dealer in the United States, with 2022 revenue of $27 billion and about 250 dealerships, plus 55 collision centers. The firm also has 13 AutoNation USA used-vehicle stores, a captive lender, four auction sites, and three parts distributors all across 19 states primarily in Sunbelt metropolitan areas. New-vehicle sales account for nearly half of revenue; the company also sells used vehicles, parts, and repair services as well as auto financing. The company (formerly Republic Industries) spun off its waste management unit (Republic Services) in 1999 and its car rental businesses (ANC Rental) in 2000. Wayne Huizenga founded the company in the 1990s to bring the rollup acquisition strategy to auto retailing, which has proved to be a smart move.	53.4%	8.1x
OC	Owens-Corning Inc	Owens-Corning Inc is a manufacturer of glass fiber utilized in composites and building materials. It has an integrated business model with three reportable segments: Composites, Insulation, and Roofing. The company generates maximum revenue from the Insulation segment. Its Insulation segment manufactures and sells thermal and acoustical batts, loosefill insulation, spray foam insulation, foam sheathing, and accessories. It also manufactures and sells glass fiber pipe insulation, energy efficient flexible duct media, bonded and granulated mineral wool insulation, cellular glass insulation, and foam insulation used in above- and below-grade construction applications.	54.7%	11.9x
PATK	Patrick Industries Inc	Patrick Industries Inc makes and sells building products and materials for recreational vehicles and manufactured housing. The company is organized into two segments based on product type: manufacturing and distribution. The manufacturing segment, which generates the majority of revenue, sells laminated and vinyl products that include furniture, shelving, cabinets, bath fixtures, and countertops. The distribution segment sells prefinished wall and ceiling panels, as well as electrical and plumbing products for the RV and manufactured-housing industries. One of the firm's RV customers makes up a significant portion of revenue. Nearly all of Patrick Industries' revenue comes from North America.	33.6%	11.6x

At our firm, we prioritize regular dialogue with you to address evolving circumstances and maintain a thorough understanding of your goals. Your decision to entrust us with your business is not taken lightly, and we greatly value your patience. Our dedicated client-service team will continue their efforts to arrange a meeting with you, as per our usual practice. Should you prefer an earlier appointment, please feel free to reach out to us at your convenience. We eagerly anticipate hearing from you.

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