July 25, 2024

COMMENT ON PERFORMANCE

The Fund performed in line with our benchmarks with less volatility during the quarter. There were no major changes to our underlying holdings and there was minimal trading activity over the past few months. We exited three of our smaller long positions and ended the quarter holding more cash than when it started. We are in the process of redeploying that capital and are finding plenty of opportunities.

MARKET COMMENTARY

Our market commentary applies only to the first half of the year and everything from July 11th onwards will be covered in the following section. We feel it is important to address the first six months of the year separately from the past two weeks. In our view, three key themes were noteworthy from January through the end of June.

First, the great narrowing continued. The performance spread between large cap growth stocks and small cap value stocks was historic (Appendix A). The MAG7 became the MAG3 and then the MAG1. The theme of the year has been the AI trade, and NVIDIA (NVDA) has contributed a disproportionate share of the year-to-date index gains. The S&P 500 (SPY) returned +15.3% compared to the S&P Equal Weighted Index (SPW) +5.1%.

The extreme bifurcation is difficult to put into words (Appendix B). Though the S&P 500 made fresh highs in Q2, only 25% of the stocks within it made new all-time highs. To illustrate this dichotomy, in the 18 trading days between May 22nd and June 18th, NVIDIA added $1 trillion in market cap. Warren Buffet has spent nearly sixty years building Berkshire Hathaway, which is currently worth $933 billion. Putting it together, NVIDIA increased its market cap by more than the entirety of Berkshire Hathaway in less than one month (Appendix C). Meanwhile, returns on the Russell 2000 were negative during this time, and plenty of the index constituents were making new all-time lows.

Second, meme stocks – accompanied by a renewed enthusiasm for financial nihilism – is back in full force. We believe this is an interesting example of rational irrationality. If a generation already feels utterly hopeless then Russian Roulette doesn't seem like such an outlandish idea. Worst case scenario, you zero out and declare bankruptcy, which is not perceived to be such a significant step down from your original situation. Best case scenario, you end up with life-changing money.

Roaring Kitty sent GameStop (GME) parabolic, and the company took full advantage of that by pumping out a massive secondary offering. AMC Entertainment Holdings (AMC) followed the same playbook and raised equity too. Chewy (CHWY) was +36% intraday on June 27th because he tweeted a picture of a dog. Ironically, the Robinhood app has gamified stealing from the poor and giving to the rich, but we digress.

The point is animal spirits are back in full force and this sort of fervor is not just confined to meme stocks. If we gauge sentiment in other parts of the market, we can't help but notice the following. NVIDIA CEO, Jensen Huang, went viral for signing autographs for women as if he was a rockstar or professional athlete (Appendix D). Short interest is exceedingly low (Appendix E), the Levkovich Index is in euphoria territory (Appendix F), and Bitcoin has rallied ~4x since the beginning of last year.

Economic data is decelerating but weakness seems to be compartmentalized. Discretionary retailers and discount stores are under pressure as the low-end consumer appears to be struggling the most. Same-store-sales are negative and, when adjusted for inflation, even more negative in real terms. Compounding the problem is higher labour costs and elevated shrinkage levels. Meanwhile, those with significant financial assets are doing quite well.

THE GREAT ROTATION

Momentum was the single best performing factor as investors spent the first half of the year chasing technology stocks into the stratosphere. Anything AI adjacent had a consistent bid underneath it whereas pretty much everything else drifted aimlessly or went lower. That changed – and changed quickly – on July 11th.

The latest CPI print was released that morning and came out better than expected. Year-over-year inflation clocked in at slightly less than 3%, the lowest since March 2021, and the month-over-month inflation was negative for the first time since May 2020. Waning inflation data theoretically puts the prospect of rate cuts into focus.

The market reaction throughout the trading day was truly historic. Treasury yields plunged, investors dumped the MAG7 stocks, and piled into small caps, interest rate sensitive sectors, and overleveraged companies. The Russell 2000 closed 4.42 standard deviations above its 50-day moving average. Calling it a trend reversal would be a profound understatement (Appendix G).

In our opinion, the magnitude of the move was impressive, and the inflation data was significant enough to suggest notable change could be on the horizon in the coming quarters. However, one month is only one month, and further evidence is required to prove this is a sustainable rotation rather than a short-lived de-grossing event.

LARGE VS. SMID-CAP OPPORUNITY

The macroeconomic backdrop suggests a combination of slowing growth, rising unemployment and a variety of other metrics typically associated with stock market corrections. For that reason, we suspect the thesis laid forth in this section is early but will likely play out over the next three to five years.

In our view, we see tremendous opportunity in SMID-caps for numerous reasons. First, the underperformance of SMID-caps remains significant, even after the sharp bounce over the past two weeks. The Russell 2000 peaked in November 2021 and remains -9% from its all-time high. Since then, the S&P 500 is +18% (Appendix H).

Second, SMID-caps are expected to disproportionately benefit from abating headwinds over the next few years. Inflationary pressures from input and labour costs should meaningfully moderate. Further, declining interest rates will provide an outsized earnings tailwind as these businesses tend to have worse balance sheets, higher coupon payments, more floating rate debt, and shorter-term debt maturities relative to large caps.

Third, from an absolute valuation standpoint, SMID-caps are cheaper than large caps (excluding healthcare/biotech). The S&P 500 appears priced to perfection, leaving little room for an upward re-rating and a thin margin of safety on forward earnings expectations. Comparatively, valuations for the Russell 2000 stocks have room to re-rate higher and are less expensive even if earnings estimates are slightly too optimistic.

Lastly, sentiment on SMID-caps appears to have troughed before July 11th. Large cap technology stocks trounced everything else as being long artificial intelligence was the only trade in town. Many Russell 2000 stocks made fresh lows throughout the first two quarters of the year and the underperformance appeared to have no end in sight. This obviously changed abruptly but, beyond this immediate reversal, most SMID-caps will benefit from lapping poor numbers in the back half of this year and into next. We believe the sentiment shift will likely persist.

We can envision at least two different scenarios where the thesis outlined in this section fails to play out though. If the next recession is imminent and more severe than we anticipate, SMID-caps will almost certainly decline in value relative to large-caps over the next couple years. They tend to be lower-quality and more-cyclical businesses on average, possess worse balance sheets, and tend to be led by less impressive management teams.

Another way in which we could be wrong is if artificial intelligence really does take over the world and the primary beneficiaries are large incumbents who use generative AI to enhance their economic moat. At current valuations, it appears the market views their first mover advantage as insurmountable. However, as we look backwards at historical examples of revolutionary technological innovation, it has always been small nimble disruptors that upend the business models of old-economy behemoths.

INVERTED LONGS

Last quarter we wrote about closing our long position in Nike (NKE). While our original thesis somewhat played out as expected, we underestimated the degree of deterioration in the rest of the business. The apparel landscape was clearly evolving, and the company was under increasingly intense competitive pressure. Investors were quietly beginning to wonder about the durability of its moat. Our decision to exit was straightforward.

Since then, the stock is down another ~25% and reminds us that sometimes your best short ideas can come from your long book, and vice versa. It can be challenging to pivot mentally and reverse the lens with which you view the potential opportunity, but great investors possess that kind of intellectual flexibility. Perspective is everything.

In hindsight it seems obvious. We would have noticed that Nike had all the hallmarks of a decent short if we had stripped away the name of the stock and simply described its generic characteristics. The fundamental reasons mentioned above combined with a rich absolute valuation puts meat on the bone. Further, investors experience anchoring bias with respect to forward estimates, so gradual changes cause revision cycles to last many quarters. Negative business momentum is also difficult to turn around, skewing the odds of a downward surprise.

Eventually, management credibility becomes severely damaged after multiple consecutive disappointing reports. Investors throw in the towel and puke out their positions just so they don't have to look at the stock on their screen anymore. At this point, you're looking at trough fundamentals, valuation, and sentiment. This is when the real turnaround story begins. We'll be ready to mentally pivot on Nike and revisit as a potential long opportunity.

PORTFOLIO UPDATE

As of the end of the second quarter, the Fund carried a net exposure of ~70% while being more concentrated than usual. The Fund's positions were primarily U.S. listed with the most notable exception being Colliers International Group (CIGI). Our holdings did not experience much turnover throughout the past few months. We exited a few non-core smaller positions and remain ready to deploy the additional dry powder as opportunities present themselves over the coming months.

LOOKING AHEAD

The S&P 500 currently trades at ~20x FY25 EPS while the MAG7 have an average multiple of ~33x FY25 EPS. We believe elevated valuations will likely result in disappointing inflation-adjusted forward returns over the next decade even if underlying business execution is satisfactory. While economic data is decelerating, it does not yet appear catastrophic enough to ignite a momentum reversal.

As such, we remain cautiously optimistic for the time being. We continue to monitor the macroenvironment for exogenous events that could drive a momentum reversal given the lofty valuations and optimistic sentiment. For instance, potential warning signs could include renormalization of the yield curve, interest rate cuts, generative AI enthusiasm waning, mega-cap earnings disappointments, etc.

Our primary focus right now is on the potential opportunity set in the SMID-cap space. This involves a combination of relooking at stocks we have previously researched and scouring the Bloomberg Terminal for new rocks we have yet to turn over. We anticipate our Fund will get less concentrated as we deploy capital into new positions but reserve the right to change our mind if market conditions drastically change.

Sincerely,

A. Agostino

Alexander Agostino

APPENDIX

Appendix A:

Chart 4: Large cap growth reached 24-yr high vs. small cap value
Large cap growth (SGX) vs small cap value (RUJ) - price relative

Source: BofA Global Investment Strategy, Bloomberg, GFD Finaeon

BofA GLOBAL RESEARCH

Chart 5: Russell 2000 reached all-time low vs. Nasdaq in July
Russell 2000 vs Nasdaq Composite - price relative

Source: BofA Global Investment Strategy, Bloomberg

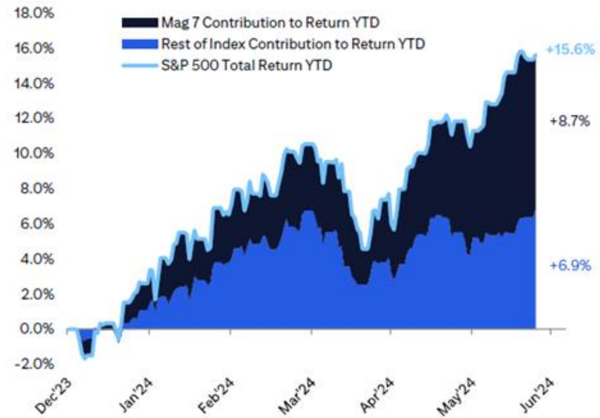
BofA GLOBAL RESEARCH

Source: BofA Global Research – The Flow Show – July 18, 2024

Appendix B:

Mag 7 vs. Rest of Index YTD Returns

Contribution to S&P 500 Return YTD, Mag 7 vs. Rest of Index



Source: Citi Research – U.S. Equity Strategy – June 25, 2024

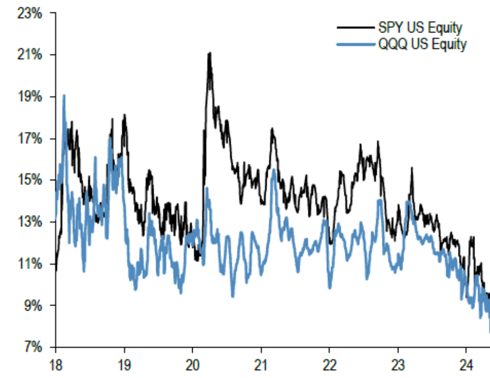
Appendix C:

Appendix D:

Appendix E:

Figure 1: Short interest on the SPY and QQQ US ETF

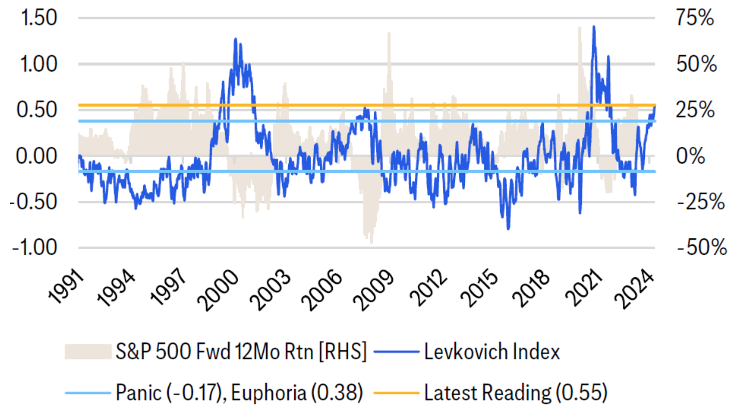
Short Interest as a % share of share outstanding. Last obs is for 18th June 2024.



Source: J.P. Morgan – Flows & Liquidity – June 26, 2024

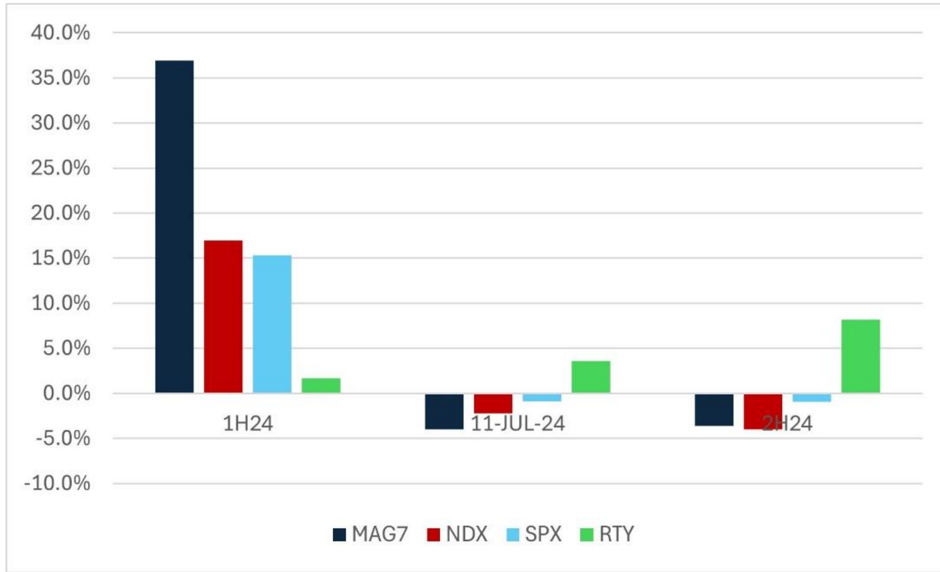
Appendix F:

Levkovich Index (Formerly Panic/Euphoria)



Source: Citi Research – The PULSE Monitor – July 22, 2024

Appendix G:



Source: Kinsman Oak Capital Partners Inc.

Appendix H:

Source: Bloomberg

LEGAL INFORMATION AND DISCLOSURES

This commentary is intended for informational purposes only and should not be construed as a solicitation for investment in the Kinsman Oak Equity Fund. The Fund may only be purchased by accredited investors with a high risk tolerance seeking long-term capital gains. Read the Offering Memorandum in full before making any investment decisions. Prospective investors should inform themselves as to the legal requirements for the purchase of shares.

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