

platinumportfolios

thoughtful investing for private clients

The Business of Broken Hearts: Lessons From “The Magnificent Seven”

By Mel Meltzer

Every market bubble, while unique, ends the same way – with significant investor losses. This pattern underscores the necessity of adhering to sound investment principles. Investing in companies or assets that one fully understands and within one's area of competence remains critical.

In 2006, no one could predict that an earthquake with the energy of 23,000 Hiroshima-type atomic bombs would trigger one of the most devastating tsunamis in the Indian Ocean. Similarly, another unforeseeable tsunami was the 2008 financial crash. But what triggered this devastating wave?

One catalyst was the love and subsequent death of Johnny Cash and June Carter. Their deaths highlighted the "broken heart syndrome," a statistical phenomenon where the death of one partner increases the chances of the other's demise. Actuarial scientist Xiang Li drew parallels between this and financial markets, using mathematics to model how the default of one company could impact others, leading to the creation of the Gaussian copula function for default correlation.

Li's model revolutionized risk management, allowing banks to package and trade risk like ordinary securities, leading to a boom in structured finance. However, the interdependence of mortgage loans wasn't fully captured, leading to the explosion of collateralised debt obligations (CDOs) and, ultimately, the 2008 crash. The misuse and misunderstanding of Li's formula, coupled with excessive greed, triggered this financial tsunami. Markets, particularly the mortgage market, proved more prone to extreme correlation scenarios than anticipated, making the financial crash a catastrophic event that was hard to predict accurately.

Current market valuations are historically high, driven by the "Magnificent Seven" tech companies: Nvidia, Apple, Microsoft, Amazon, Google, Meta, and Tesla. This concentration resembles past bubbles. Despite high expectations, growth estimates for AI-related stocks are not wildly demanding, but their valuations have surged dramatically. For example, analysts predict a 23 percent annual growth rate for Nvidia over the next few years, a moderation from its 50 percent annual growth over the past five years. Other major tech companies have similar growth expectations, reflecting both cautious optimism and significant investor interest.

The AI rally has pushed the price/earnings ratios of key tech stocks up significantly. This could reflect momentum and optimism about long-term profits. However, non-AI stocks have generally underperformed, signalling caution about the overall economy. Since March, non-AI stocks in the S&P 500 are down 2 percent on a market-weighted basis, with defensive sectors like utilities, staples, and healthcare doing relatively well, while cyclicals like energy, materials, and industrials are underperforming.

One internal tension within the AI rally is that Nvidia's success is a drag on the cash flows of Big Tech companies, which buy the bulk of Nvidia's chips. This dynamic indicates that the profitability of AI investments is intertwined with broader market forces, and the sustainability of this rally may depend on continued high spending from tech giants or an expansion of Nvidia's customer base beyond the current major players.

To avoid the pitfalls of speculative excesses, we at Platinum Portfolios must remain grounded in fundamentals, investing within our circle of competence. We focus on our process and metrics to determine the right price to pay for companies. This discipline, honed over the last 24 years, has guided our investment decisions. The lessons from the 2008 crisis and current market dynamics highlight the importance of rigorous analysis and cautious optimism in navigating market bubbles. Experience has shown that sticking to our simple investment principles and disciplined process helps avoid catastrophic failures. It is crucial not to succumb to the fear of missing out or blindly follow the herd, as these behaviours can lead to disastrous financial outcomes.

At Platinum Portfolios, we prioritize understanding the fundamentals of our investments to protect our investors' financial interests.

-END-