ONEILL
STUDENT INVESTMENT FUND

**Memo**: Investment Letter:
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**To**: OSIF Board
**Date**: Aug 11, 2023

Dear OSIF Faculty Advisors & Board of Directors;

The students of the Summer class of 2023 would like to begin by expressing thanks to the Board for the chance to learn from professional money managers, and test out our theories by actively trading in the markets. This course is a tremendous opportunity to gain invaluable experience that only trading professionals generally have access to.

Both Karan Iraddi and Chris Magana offered their hard earned experience for our benefit (and to the benefit of the fund) seizing upon moments afforded by current events to provide insights into how financial markets work using socratic teaching methods. Please accept the following as our report on fund activities during the Summer term of 2023.

**<u>Macroeconomic Environment</u>**

The macroeconomic environment provided interesting volatility during our term. Most macro conditions can be considered after-shock effects on the economy from the COVID-19 pandemic. These after-shocks were driven chiefly by Fed Funds Rate hikes, a mixed earnings season and unrealized fears of a recession in 2023.

The rate hikes are the Fed's response to record high inflation of 9% in June of 2021, a level not seen since 1982. This inflation results from the U.S. Treasury's response to COVID-19 by injecting $5 Trillion into the economy. The Fed raised rates twice during our term. Each rate increase was 25 basis points leaving the current rate at 5.25% to 5.5%, the highest rate in 15 years. This resulted in an inverted bond yield curve such that short term bonds are yielding higher returns than long term bonds. This context resulted in volatility in the banking industry including three regional bank failures (Silicon Valley Bank, First Republic & Signature Bank), Silicon Valley Bank (SVB) failed as a direct result of rate increases. The rate increases caused SVB to have to sell some of its bonds at huge losses to cover its deposits. Word of this got out causing a run on deposits and ultimate failure of the bank.

Earnings in the second quarter delivered mixed results. In general, companies have increased revenues with lower profits and weaker forward earnings guidance. Why were profits lower? The consensus has been that a recession would hit at some point this year, but Fed Chair Jerome Powell stated that he still believes that there is a path to a soft landing. Soft landing optimism for the current economy can be found elsewhere among analysts, yet some say that a soft landing narrative also preceded previous recessions.[1]

Industries that saw major shifts during this term were tech and healthcare. Tech saw major shifts via wider adoption of AI which produced an increased demand for the advanced chipsets that can run such programming and a surge in valuation for those chip makers. Healthcare insurers were negatively impacted by members opting to have elective surgeries that were put on hold during COVID.

The geopolitical landscape was shaped by the conflict between Russia and Ukraine and other central banks' rate decisions. The war in Ukraine persists with no end in sight. Other economies find themselves at different points on the path to recovery precipitating different rate decisions. The European Central Bank and the Bank of England have been raising rates. At the same time, the Bank of Japan is loosening its grip on quantitative easing, and China is tightening its monetary policy to stimulate its economy. This environment creates uncertainty which is hard to predict.

## Fund Performance & Decisions

### *Performance vs. Benchmarks*

Despite uncertainty in the macro-economy, and market volatility, 2023 has seen a surge in valuations. The markets were beaten down in 2022 due to restrictive monetary policies and are pricing in an expected pause to rate hikes after maybe one more later this year. The fund outperformed the S&P 500 Blend with 70% stocks and underperformed by a small margin against the other benchmarks (which reflect less cash and bond holdings than the Fund held through the term, mostly due to time required to learn the basics of investing).

### *Performance for the Summer '23 Term:*

| | 1 Month | 3 Month | 1 Year | 3 Year |
|---|---|---|---|---|
| **O'Neill Fund** | **+2.9%** | **+7.4%** | **+4.1%** | **+2.6%** |
| **Index Blend 70% Stocks** | +2.6% | +6.12% | +8.5% | +6.9% |
| **S&P 500 Index** | +3.2% | +10.5% | +13.0% | +13.7% |
| **Russell 1000 Index** | +3.4% | +10.9% | +12.9% | +13.2% |

[1] ""The prevailing consensus right before things went downhill in 2007, 2000 and 1990 was for a soft landing," said Gennadiy Goldberg, a rates strategist at TD Securities."
https://www.nytimes.com/2023/07/27/business/economy/fed-economy-soft-landing.html

***Best Decisions***

The best decision we made this year was to buy M&T bank. This decision was made during the turmoil around the regional bank failures. The thesis was this: we expected that the Fed would continue raising rates and/or increase banking regulations around required reserves. This environment would favor those banks with strong cash coverage, so we looked for a regional bank that had been beaten up along with the rest of the regional banks, yet had several other traits that gave us confidence it would survive reasonable actions by the Fed and regulators. Additionally, we noted that at least one regional bank had experienced significant volatility in the short term; Pacific West Bank. It had been really beaten up on value from $30 in March down to $3.17 in May on fears of failure. After going down so low, it made a comeback throughout May since it didn't fail. This caused it to turn up on high volatility lists with triple digit moves. We thought that there may be other regional banks which had been caught up in the frenzied regional bank equity sell-off, that we could scoop up for a bargain and have a short ride to a respectable profit.

To find such a bargain, we looked at analyst reports and four indicators for twelve regional banks. The four indicators were (1) Beta, (2) Performance in 2021, (3) YTD (as of 5/19/23), and (4) Cash Coverage (Cash / Liabilities). We were looking for regional banks that tracked the market reasonably well, participated in the 2021 stock market run up, were beaten up this year, and had the cash to cover our expected future state of nature: higher reserve requirements or rates. This framework[2] and the analyst reports returned M&T Bank as the best candidate with a potential upside of 46%, so we decided to build a $15,000 position over 3 weeks. This returned about 11% from our purchases in June to selling on August 4th. We closed the position as banking has become increasingly uncertain and the remainder of the expected recovery is not expected in the near term.

Another good decision was that we held Google parent Alphabet. While assessing our current positions within the portfolio, Google was down in the low-teens from when it was initially purchased and lagging all other positions in the portfolio. In our analysis of the firm, Google appeared to be losing market share to Microsoft and Amazon in both the cloud computing and digital advertising spaces, and experiencing high competition in the hardware and service spaces from Apple among other firms. Our initial analysis was that while we were confident in Google's ability in the long term, we expected continued share erosion over the next six to twelve months and felt it may be a candidate to reallocate our assets elsewhere. However, since the portfolio already had significant positions in tech via Microsoft, Amazon, and Apple, we decided to hold as there was no better alternative investment at the time. This decision proved to be good as the company defied our analysis by delivering a strong second quarter and returned 9.9% over the course of the summer term.

***Lessons Learned***

The M&T Bank trade was inspired by the wild swing we saw in PACW. Through this trade we learned to look for bargains among irrationally beaten down equities. We also got experience in chasing that inspiration by learning as much as possible about our ideas in order to build evaluatory frameworks. Through holding Google, we learned that sometimes leading

[2] https://docs.google.com/spreadsheets/d/1d8TxnHutS4qq1ki51zCAjE9CU0VLdyEXibmSpxciSis/edit?usp=sharing

companies can be winners despite a poor outlook, so there are times when it is better to trust the long term performance of the company over the short term struggles.

### *Worst Decisions*

Our three poor decisions resulted in the Fund not pacing with the market. The first poor decision was our decision not to take more time to rebalance as mentioned earlier. This probably had the largest negative effect on the fund during our term. The second and third poor decisions were buying Eli Lilly (LLY) and not buying Charles Schwab (SCHW). The LLY purchase grew out of an effort to optimize the portfolio's current holdings. We were holding JNJ and considered closing that position. In that effort, it was suggested that if we wanted to get into pharmaceuticals, we should consider LLY. After considering it, we felt that it is a strong stock with a great history yet with some questions on patent protection and product pipeline. It was projected to have strong earnings/revenue from new drugs. Thus, we decided to move forward with an investment of $10,000 using dollar cost averaging over two weeks. Thus far, the drug manufacturing sector has seen mixed results with the entire sector seeing a drop off over the past month with JNJ rallying as they spin off one of their divisions. Our LLY position has returned -1.1%. However, we still believe in both the company and the sector long term.

We missed Charles Schwab primarily due to needing to discuss it earlier. We had the idea in late June of 2023 and we tabled the discussion for two class periods, missing the majority of its recovery (up to now). That made us hesitant to get in since we knew it was trading at $55, down from $76 at the start of the banking downturn in March, and by the time we discussed the firm, the stock had recovered up to $60. This had eaten away much of the profits for our base case scenario of around $65, and with the uncertainty in banking, we were not able to get enough votes to buy in, so we passed.

### *Lessons Learned*

We learned from not taking the time to rebalance just how important that practice is for portfolio management. LLY showed us that past performance has no promise of current or future performance, and also to be aware of a firm's entanglement in the performance of its market sector. SCHW reminded us that time is a consumable and limited resource which is of the essence in making trading decisions. Thus, we should prioritize our discussions around where we see the most opportunity for profit.

## Future Outlook

### *Volatility due to Uncertainty*

We believe the next quarter will bring volatility due to uncertainty in the economy, geopolitics and the inverted bond yield curve. The economic uncertainty will come from another rate decision and continued fears of recession. The Fed's decision around another expected rate hike this year is not a sure thing. This uncertainty will provide volatility in equities as different strategies are employed in the markets to brace for different expected outcomes. Student loan payments will resume this fall which will reduce consumer discretionary spending by about $7.4 Billion per month[3]. This, in conjunction with decreased profit guidance from earnings season could be a leading indicator of decreases in the Consumption and Investment inputs to GDP (as these two are generally the lion's share of GDP) which could lead to poor economic performance, as measured by GDP, for Q4 of 2023. One quarter of poor GDP numbers could stoke recession fears. That said, there is always the possibility that the market has already priced in a recession which could indicate that now is the time to buy in as there is a lot of upside potential in valuations.

The uncertainty around Russian aggression in Ukraine and a potential alliance forming with Asian and Middle Eastern states could also cause investors to deploy more protective investment strategies leading to a sell off in equities in favor of bonds. One play that we made to address this potential market move is taking a $15,000 position in Invesco Aerospace and Defense (PPA). We recommend holding this one long term due to uncertainty in the geopolitical landscape for the foreseeable future.

Lastly, the bond market seems to be in a historically significant moment. An inverted yield curve has preceded eight out of the last nine recessions since 1955, thus the current inversion and the afore-mentioned market conditions are leading many to expect a recession in the near future. This may prolong the inversion as more investors pile into short term bonds to realize the short term, risk free gains. Regardless, the consensus among market analysts is that there will be at least one more rate increase sometime likely in Q3 or Q4 of 2023. Therefore, the short term bond market will continue to offer historically high, risk free returns during the Fall school term.

**Advice for Fall 2023 Students**

Trimming positions that have weak hold theses in favor of a short term bond strategy would be worth strong consideration. A bond ladder may be a good play since short term yields are so high, taking advantage of the near-term treasury bill rates that are higher than 5%. This could be a shelter for cash, or a better alternative for assets currently tied up in equities that students perceive to have a poor short term outlook. We have a few guiding principles that may be helpful during what we feel is shaping up to be a really interesting few months in the markets. Know your risk tolerance, be curious, and ask questions to understand what the risk is or could be. Our view of the cumulative condition of the Fall markets is that they will be volatile and challenging to navigate rewarding vigilance, knowledge, and luck.

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[3] This estimate is based on 37 million borrowers whose payments will resume (https://www.forbes.com/advisor/student-loans/student-loan-payments-resume/), and the average payment of $200 per month (https://www.experian.com/blogs/ask-experian/research/average-student-loan-payments/#:~:text=Student%20loan%20borrowers%20will%20make,years%2C%20according%20to%20Experian%20data.)