O'Neill Investment Letter

Dear OSIF Board of Directors,

We are thankful for the opportunity to have managed the O'Neill investment fund. Our sincere appreciation goes to our professors Ernesto Toskovic and Gilbert Park for providing us with valuable insights throughout the semester. This spring, we strategically managed the current portfolio amidst changing fixed-income dynamics, supply chain disruptions, and continued geopolitical tensions. This summary will delineate our decisions in light of these factors and provide our near-term outlook for the investment fund.

Macroeconomic Environment

2024 has started with strong equity performance due to a "dovish" Federal Reserve as investors expected the Federal Reserve to cut interest rates starting as soon as the summer if inflation was reduced to the target rate of around 2%. However, March's Inflation report disappointed investors, detailing that the Consumer Price Index (CPI) rose 0.4% in March and 3.5% annually. The expectations for the CPI were 0.3% for March and 3.4% YoY. With these higher-than-expected inflation readings, the Federal Reserve will most likely hold interest rates steady in the near future, making a summer interest rate cut less probable. Decreasing inflation has been difficult and a much slower process than expected. However, in the long term, we expect inflation to return to the Fed's target rate of 2%.

Real Gross Domestic Product (GDP) increased at an annual rate of 3.4% in Q4 2023, showing signs of a solid economy for the United States despite interest rates remaining higher for longer and moderate levels of inflation. The next release of GDP growth in late April will be analyzed by investors to measure the strength of the US economy.

Within the portfolio, the sector allocation remains similar to fall 2023. However, we have a lightened concentration in information technology. Compared to the Dow Jones benchmark, we remain overweight on financials as we believe that the sector is attractively valued and health care remains equal weight as our allocation towards healthcare is part of the late cycle strategy adopted in Fall 2023. Consumer discretionary is slightly overweight as we believe in investments in the space to stabilize the portfolio in case of a market correction, communication services remain overweight. Industrials, energy, materials, real estate, and utilities are underweight.

We rotated the portfolio from large-cap growth to a large-cap blend to reduce concentration in large-cap technology companies. Additionally, we increased exposure in small-and mid-caps to position ourselves for high potential upside in small-and mid-sized companies if the Federal Reserve does cut interest rates.

Fixed-Income Dynamics

The fixed-income market is currently at a crossroads, influenced by a variety of factors including inflationary pressures, monetary policy decisions, and geopolitical uncertainties. Inflation concerns have led to further speculation regarding the Federal Reserve's interest rate stance, impacting bond yields and investor sentiment. In response to rising inflation, the Federal Reserve has signaled a more hawkish stance, with discussions on tapering asset purchases and potential interest rate hikes. This shift in monetary policy has led to fluctuations in bond yields and heightened volatility in the fixed-income market. Moreover, geopolitical uncertainties, such as the conflict in Eastern Europe and supply chain disruptions, have added to market jitters. In this environment, we must carefully consider the upsides and downsides of fixed-income securities, contrasted with the strong short-term rates we've observed in money market/cash accounts. We've shifted our focus towards incorporating assets with shorter durations and inflation protection to mitigate interest rate and inflation risks while complying with our benchmark between 20–50% allocation in fixed-income (found in our Investment Policy Statement).

The recent divergence in monetary policies among major central banks, particularly the Federal Reserve's hawkish stance compared to other central banks, has resulted in yield differentials and currency fluctuations. This continued emphasis on monetary tightening, coupled with the Fed announcing its plans to gradually reduce its bond purchases to lead to a more normalized, recovered, interest rate market, have led to adjustments in yield curves and expectations for future rate hikes, impacting the pricing of Treasury securities. Additionally, geopolitical tensions and uncertainties surrounding fiscal policy measures, such as infrastructure spending and taxation, have contributed to further market volatility as a whole. This semester we continued to focus on the yield curve. We interpreted its implications for the market, which has helped us contextualize some of the unusual events taking place in domestic equity and fixed-income markets.

Geopolitical Climate

In the intricate interplay between geopolitical shifts and financial markets, the U.S. stock market often serves as a barometer of global tensions and uncertainties. Recent events, such as the Red Sea crisis and cybersecurity breaches, underscore the profound impact of geopolitical and technological threats on market stability and investor confidence.

The Red Sea crisis, initiated by Houthi attacks on vessels in October 2023, highlights global supply chain vulnerability. This crisis, intertwined with regional conflicts, disrupts critical shipping routes, affecting trade volumes and logistics operations (Kamali et al., IMF, 2024). Simultaneously, ongoing shipping disruptions in the Panama Canal exacerbate uncertainties (JP Morgan, 2024). This situation prompts changes in purchasing behavior and contract durations in the air cargo market, with forwarders seeking flexibility (Stroh, Supply Chain Dive 2024). Many shipping companies have redirected their fleets around the Cape of Good Hope for safety, while the elevated crude oil prices, averaging $88/bbl in 2Q24, are expected to impact sea cargo prices (EIA, 2024). Investors might consider companies demonstrating resilience in the face of such disruptions. Companies that have leveraged technology and network optimization to mitigate supply chain disruptions and capitalize on changing market dynamics, can offer opportunities for investors seeking exposure to the air cargo sector.

Cybersecurity has emerged as a critical issue in 2024, notably highlighted by the recent cyberattack on one of our holdings, UnitedHealth Group (UNH). This attack has significant implications for both the company and its investors, resulting in a class action lawsuit and regulatory investigations, underscoring the vulnerability of healthcare organizations to cyber threats ("UnitedHealth Group is facing a class action lawsuit after hackers say they stole a significant amount of data during a February ransomware cyberattack") (Baude, KSTP, 2024). The disruption caused by the attack, including delays in prescription availability and insurance verification processes, has raised concerns about patient confidentiality and data protection in the healthcare industry (Capoot, CNBC, 2024). This uncertainty surrounding the cyberattack's impact on UnitedHealth Group's operations and financial performance may adversely affect investor sentiment and stock performance in the short term. Hence, portfolio managers should closely monitor developments related to the cyberattack and assess the company's response measures, including cybersecurity enhancements and regulatory compliance efforts, to mitigate potential risks and safeguard long-term investment interests.

Despite facing headwinds such as regulatory crackdowns and economic deceleration, the long-term growth prospects of China remain promising. Since January 2024, China has faced heightened regulatory scrutiny across various sectors, with notable crackdowns on technology companies, education firms, and property developers. These regulatory actions, aimed at addressing systemic risks and promoting fair competition, have introduced short-term uncertainties but underscore the government's commitment to fostering a stable and sustainable economic environment. Notable events include the imposition of fines on tech giants for anti-competitive behavior, stricter regulations on the private tutoring industry, and measures to address property market speculation. As investors, we must continue to monitor China’s regulatory landscape, geopolitical environment, as well as the Chinese equity markets closely to capitalize on opportunities we can identify that arise from market corrections, volatility, and uncertainty.

Investment Decisions

We initially decreased our position in Adobe due to the rise of text-to-image generation tools provided by competitors and their slow transition to implement their text-to-image tools. Additionally, the thesis for investing in Adobe from previous portfolio managers' was due to the belief in the failure of the antitrust lawsuit regarding their acquisition of Figma. This lawsuit passed leading them not to acquire the company, contrary to the class belief. We then continued to exit the holding as we observed our initial thesis of increased competition and a rebalance of our portfolio to at least 20% fixed income.

We decreased our position in Google due to a decrease in quarterly revenues. This was primarily driven by the loss of searches to entities like ChatGPT and Bing who we believe will continue to capture market share as Google has announced their AI will be a pay-to-search feature. This loss of revenues coupled with anti-trust lawsuits they continue to face create vulnerabilities that could continue to hurt future growth. With losing searches to other mass information outlets we found this the best holding to decrease to limit our exposure to tech and realign compliance with our Investment Policy regarding fixed income.

We decreased our position in Apple due to increased competition in smartphones, stagnating revenues of iPhone sales globally, and economic troubles in China. These decline in sales and economic factors coupled with recent antitrust accusations informed us to trim the position to limit our exposure to the downside caused by these factors. This decision was also influenced by maintaining our Investment Policy holdings requirement.

Fund Performance

We are pleased to report another semester of strong performance for our fund. Through strategic portfolio adjustments detailed in this letter, we successfully reduced the portfolio's risk profile, evidenced by a decline in both standard deviation and beta from their previous levels. During our time with the fund, we achieved an impressive return of 10.32%, growing from an initial value of $479,251 to $528,733. This performance not only surpassed the S&P 500 by 0.67% but did so with reduced volatility and lower risk, as reflected in our lowered standard deviation and beta values.

Our narrative this semester of derisking was successfully accomplished as can be seen by our lower annualized standard deviation and beta value of the portfolio from the previous semester. Our beta value was reduced from 0.77 to 0.

Our portfolio's standout performers this period were Amazon, Eli Lilly, Microsoft, and Costco. Each of these companies delivered exceptional results, with returns exceeding 50% during our holding period. However, not all segments of our portfolio met these high standards. We experienced lesser performance from other megacap firms such as Apple, and Google.

In response to the market dynamics, we adjusted our holdings in Apple, reducing our position by half and securing an average profit of 18%. Adobe emerged as a significant winner for us; we capitalized on this by selling a substantial portion of our stake at a 65% return, with the remaining shares sold at a 45% return. This decision was guided by our assessment that it was the optimal time to exit the position.

Market Outlook

In early 2024, there was an initial expectation that US inflation would decline towards the Federal Reserve's 2% target, leading to anticipation of three interest rate cuts. However, the situation has deviated notably from these projections. Rate reductions may now be postponed due to the presence of persistently high inflation measures, notably from the PCE and CPI data. The lack of sufficient progress in the first quarter of 2024 has delayed the Federal Reserve's consideration of easing monetary policy, resulting in a likely delay of the first-rate cut to happen in September 2024. Furthermore, record-high gold prices, the strong price of the dollar, and rising 10-year bond yields indicate that near-term borrowing will be expensive if rates remain steady.

The escalation of geopolitical tensions between Iran-Israel, Palestine-Israel, Russia-Ukraine, and US-China is expected to lower economic activity by increasing the fragmentation of global trade flows and financial intermediation. Additionally, it will drive up financing and production costs and contribute to more sustained supply chain challenges and inflationary pressures in 2024. Currently, the U.S. debt stands at nearly $34.5 trillion, indicating potential impacts such as reduced business investment and slower economic growth, which serve as a cautionary tale for investors.

Note of Thanks

We thank the O'Neill family, board members, and faculty for entrusting us with managing the O'Neill Student Investment Fund. This experience has been invaluable and we deeply appreciate your steadfast support and express our heartfelt thanks for the ongoing confidence you place in us.

Sincerely,

The OSIF Spring 2024 Team

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