



MEDALLION

WEALTH MANAGEMENT

July 2024 Market Commentary

Scar Tissue



*Scar tissue that I wish you saw
Sarcastic mister know-it-all
Close your eyes and I'll kiss you, 'cause
With the birds I'll share*

Red Hot Chili Peppers – <https://www.youtube.com/watch?v=NazJpc5lcWU>

As we age, we all accumulate scar tissue. Some visible and some hidden deep inside. For Anthony Kiedis, Red Hot Chili Peppers frontman and songwriter, this song was about his drug addiction and the scars it left hidden from view. The track was the lead single from RHCP's most famous album, 1999's *Californication*, and won the Grammy for Best Rock Song in 2000. While the song deals with the dark side of addiction, it also has a hopeful melody, because scars are proof that we survived and that what doesn't kill you makes you stronger.

Let me tell you a little story about some of the investment scar tissue I've accumulated over the years. My investment career started around 1985, and I was a young 27-year-old Trust Investment Account Manager at Mellon Bank for the Black Monday crash of October 1987. That week the market plunged 33%, with some blue-chip companies down more than 50%. While this was certainly a traumatic period, I was simply too young and naïve to appreciate just how traumatic it was for those who'd been investing for decades. I did learn a couple of very valuable lessons though. Namely, be mentally prepared for your equity portfolio to lose 30% at any time for any reason, and in a panic, it's imperative to know what you own and why you own it.

While those were my first scars, the particular scar tissue I want to talk about today is from the same period that the Chili Peppers wrote about, the late 1990's and early 2000's.

As way of a preamble, I left Mellon Bank in 1990 and moved down the street to Federated Investors, where I managed their Utility Funds and Equity-Income Funds until 1997. In 1997, with the help of AmSouth Bank, I left Federated and started my own mutual fund company, Rockhaven Asset Management. My wife and I had just had our first child, and I left the well-paid comfort of a big corporation for the joys of entrepreneurship. I wasn't alone in this endeavor, I brought an analyst (Larry Eakin) and trader (Tracey Smith) with me from Federated, as well as my wife's assistant (Patty Mullen) from Deloitte & Touche.

Our goal was to build a mutual fund company that generated market returns with less risk, as we had previously done at Federated. Unfortunately, Mr. Market didn't care what my goals were. We thought we could replicate our early 1990's performance by buying quality dividend paying companies, with a convertible bond sprinkled in here and there for some yield.

Here are the returns in the market from 1995-1997:

	NASDAQ 100	S&P 500
1995	42.54%	37.58%
1996	42.54%	22.96%
1997	20.63%	33.36%

Obviously, it had been a really strong couple of years. So, there we were in early 1998 with our portfolio of rather stodgy dividend paying stocks hoping that after three great years for growth stocks, value would finally have its day. The market had other plans; Growth, especially Tech, Media, Telecom, (TMT) continued to rip higher, and we lagged.

This is where some of my stress induced scar tissue started to accumulate. I had a young company trying to attract assets, I had employees who were counting on me for a paycheck, I had investors counting on me to perform, and a wife and infant daughter at home. This was a pivotal point in my career, I had to decide quickly whether I wanted to stubbornly keep what I believed were good value stocks or find a way to run an equity-income fund to participate in what the market was rewarding, namely growth. I choose to pivot to what the market would give me...adapt or die.

We put our heads together and decided that we would find a way to buy growth with income. Fortunately, many of these up-and-coming Tech-Media-Telecom stocks were issuing convertibles to fund their growth, and we bought as many as our prospectus would allow us to do and still call ourselves an equity fund. The converts allowed us to participate on the upside while giving us some downside protection.

It was a great decision, made under stress or duress, but it worked. The growth stocks continued to rip higher, and we were able to participate.

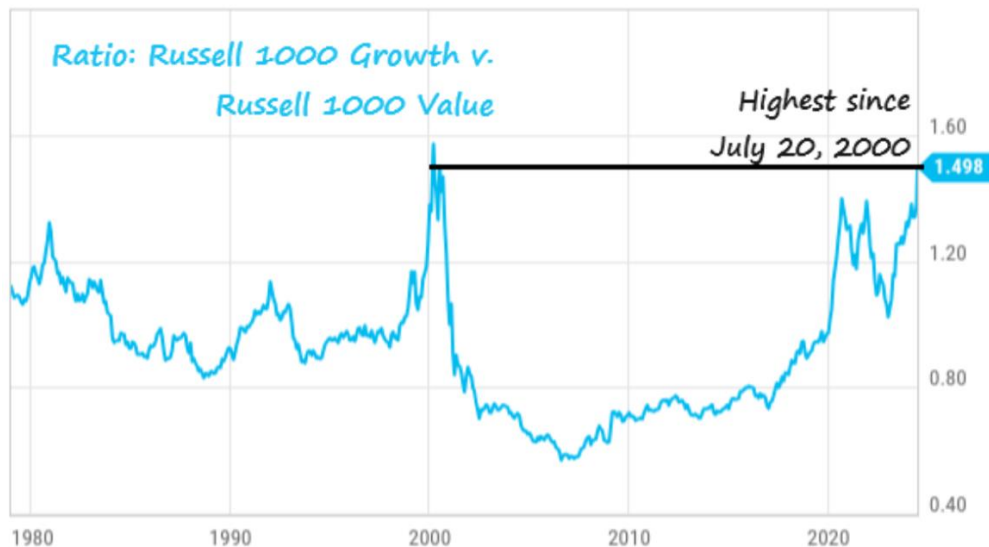
	NASDAQ 100	S&P 500
1998	85.30%	28.58%
1999	101.95%	21.04%

This was a five-year period of time that saw many value and equity-income managers lose billions in assets under management and even close up shop, as investors flocked to growth. Of course, the value managers who survived were finally proven correct as the market corrected sharply over the next three years.

	NASDAQ 100	S&P 500
2000	-36.84%	-9.10%
2001	-32.65%	-11.89%
2002	-37.58%	-22.10%

We actually ended up doing pretty well over this period. We had the only equity fund in the country that was up more than 50% in 1999 and still positive in 2000. Our performance attracted some attention and we eventually sold Rockhaven to Strong Capital Management. That's another story for another day.

The reason for this long-winded walk down memory lane is that I keep seeing people drawing similarities between today's market and the late 1990's. Growth stocks have now outperformed value stocks by a margin only seen in 1999 and 2000.



Large-cap S&P 500 stocks have outperformed Small-cap Russell 2000 stocks by a margin only seen in 1999 and 2000.



And the market-cap weighted S&P 500 (dominated by a handful of stocks) has outperformed the equal-weighted S&P 500 by a margin only seen in 1998 and 1999.

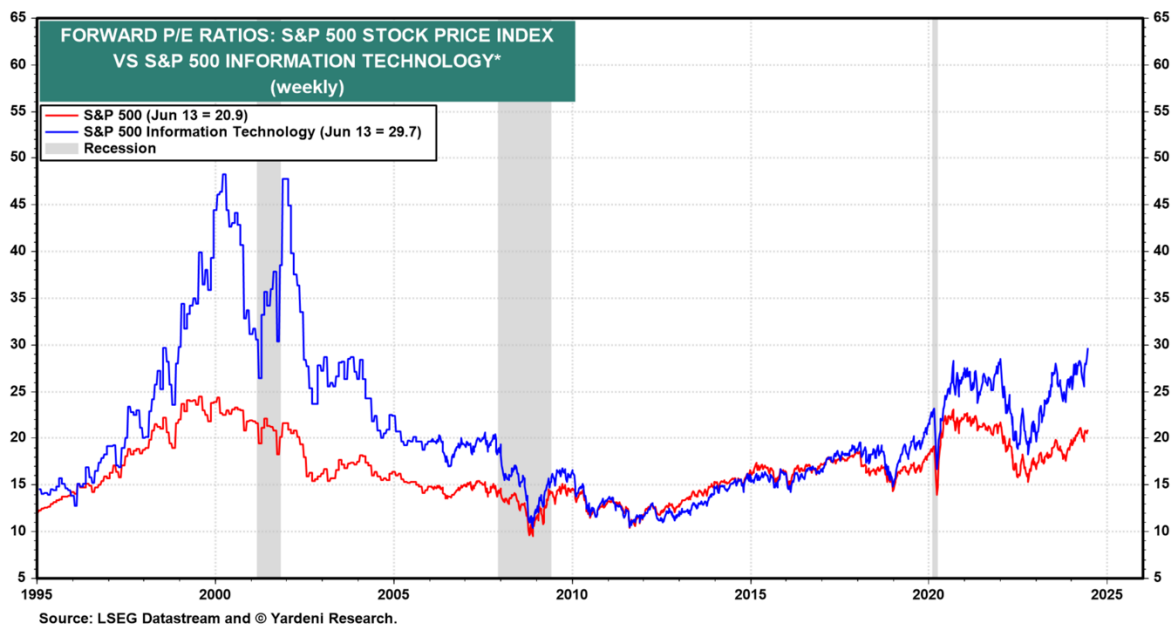
S&P 500 vs. S&P 500 Equal Weight (EQ) (Total Returns, 1971 - 2024)											
Year	S&P	EQ	S&P - EQ	Year	S&P	EQ	S&P - EQ	Year	S&P	EQ	S&P - EQ
1971	14.2%	16.6%	-2.4%	1989	31.7%	25.8%	5.9%	2007	5.5%	1.5%	4.0%
1972	18.8%	9.8%	9.0%	1990	-3.1%	-11.9%	8.8%	2008	-37.0%	-39.7%	2.7%
1973	-14.3%	-21.5%	7.2%	1991	30.5%	35.5%	-5.0%	2009	26.5%	46.3%	-19.8%
1974	-25.9%	-22.9%	-3.0%	1992	7.6%	15.6%	-8.0%	2010	15.1%	21.9%	-6.8%
1975	37.0%	54.4%	-17.4%	1993	10.1%	15.1%	-5.0%	2011	2.1%	-0.1%	2.2%
1976	23.8%	35.7%	-11.9%	1994	1.3%	1.0%	0.4%	2012	16.0%	17.7%	-1.7%
1977	-7.0%	-2.0%	-5.0%	1995	37.6%	32.0%	5.5%	2013	32.4%	36.2%	-3.8%
1978	6.5%	8.2%	-1.7%	1996	23.0%	19.0%	3.9%	2014	13.7%	14.5%	-0.8%
1979	18.5%	28.7%	-10.1%	1997	33.4%	29.0%	4.3%	2015	1.4%	-2.2%	3.6%
1980	31.7%	30.2%	1.5%	1998	28.6%	12.2%	16.4%	2016	12.0%	14.8%	-2.8%
1981	-4.7%	4.8%	-9.5%	1999	21.0%	12.0%	9.0%	2017	21.8%	18.9%	2.9%
1982	20.4%	30.2%	-9.8%	2000	-9.1%	9.6%	-18.7%	2018	-4.4%	-7.6%	3.3%
1983	22.3%	30.3%	-7.9%	2001	-11.9%	-0.4%	-11.5%	2019	31.5%	29.2%	2.2%
1984	6.1%	3.6%	2.6%	2002	-22.1%	-18.2%	-3.9%	2020	18.4%	12.8%	5.6%
1985	31.2%	30.6%	0.6%	2003	28.7%	41.0%	-12.3%	2021	28.7%	29.6%	-0.9%
1986	18.5%	17.9%	0.6%	2004	10.9%	17.0%	-6.1%	2022	-18.1%	-11.4%	-6.7%
1987	5.8%	4.9%	0.9%	2005	4.9%	8.1%	-3.1%	2023	26.3%	13.9%	12.4%
1988	16.6%	20.2%	-3.6%	2006	15.8%	15.8%	0.0%	2024 YTD	15.4%	5.5%	9.9%

Mark Twain once said, “History doesn’t repeat itself, but it does often rhyme.” And while there are certainly strong similarities between the late 1990’s and today, there are also some noteworthy differences.

One of the biggest differences between the late 1990’s and today is the quality of the companies leading the market higher. In the late ‘90’s we had many companies that came public and soared to new heights on the promise of eyeballs looking at their website. I kid you not, some analysts talked about price-to-eyeballs since there were no sales or earnings to use as a metric.

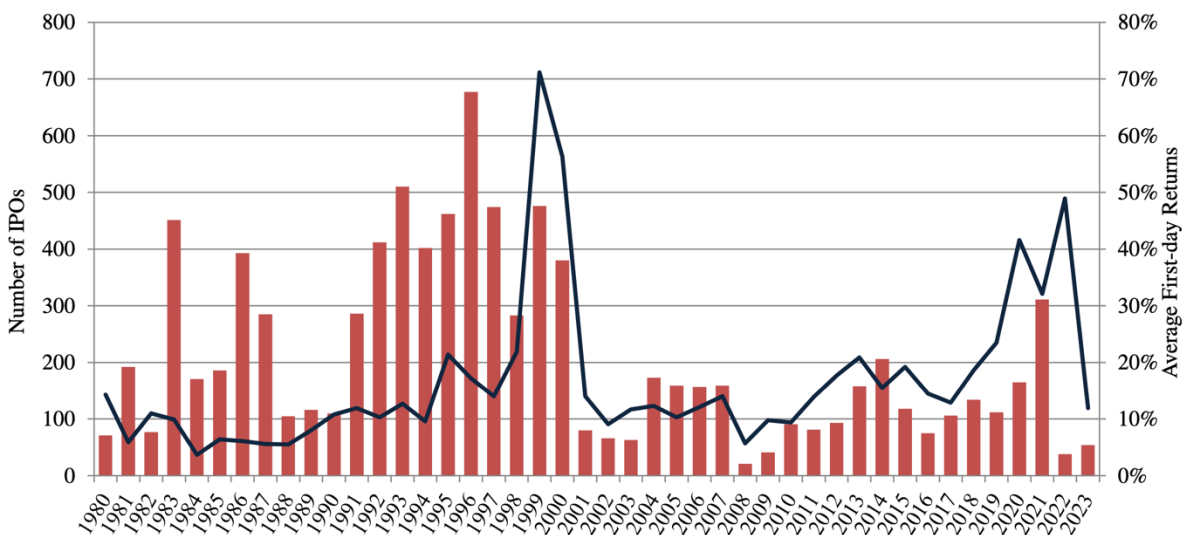
Today, the top 10 market-cap companies leading the market higher also have sales and earnings that are leading the market higher. In other words, while prices have accelerated, sales and profitability have also soared.

The chart below shows the forward price-to-earnings ratio on the S&P Technology sector and the S&P 500. Technology stocks are nowhere near the valuations that they reached in the late ‘90’s.



Also, a big difference between the late ‘90’s and today is the level of speculation that went on in Initial Public Offerings (IPOs). Back then, if you slapped “.com” on your name you could not only go public, but your stock would probably soar too. Today, not only are the number of IPOs significantly lower, the average first day returns are also low.

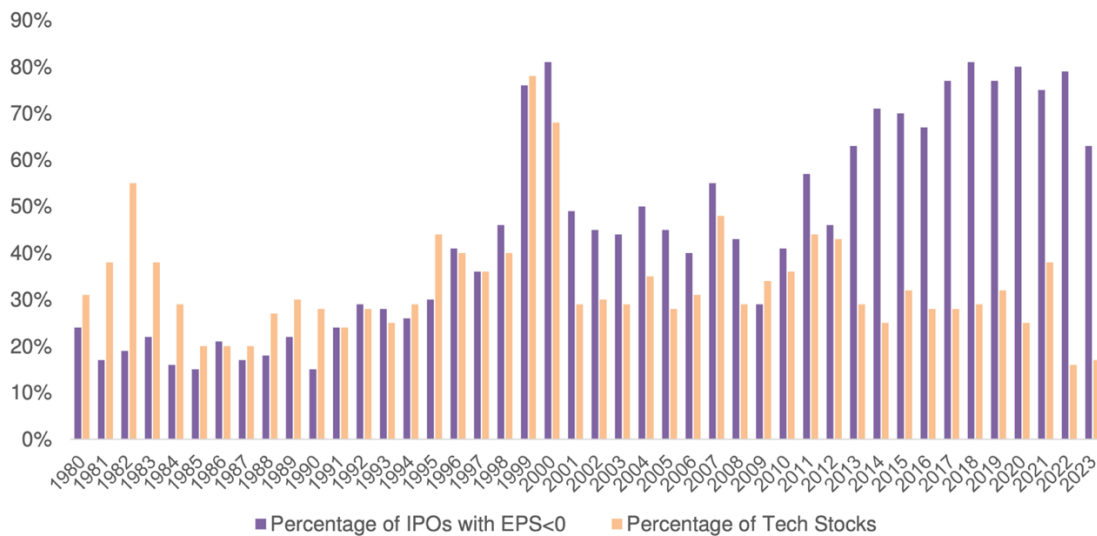
Figure 5: The number of IPOs and average first-day returns per year, 1980-2023



-Jay Ritter, University of Florida

In 1999, nearly 80% of all tech companies that went public had negative earnings, today that number is closer to 15%.

Percentage of IPOs with Negative EPS and Percentage of Tech Stocks, 1980-2023



-Jay Ritter, University of Florida

So, while there are numerous comparisons to be made between the 1990's and today, there are also numerous differences. Parts of history are rhyming, but other parts are singing a totally different tune.

This doesn't mean I'm sanguine about where we are in the market today, quite the contrary, my "spidey senses" are tingling. The years of accumulated scar tissue have taught me to expect the unexpected, and after an exceptionally strong run of performance it feels right to raise a little cash.

No one can time the market, but we believe it is prudent to take some profits after such a powerful move upward, which is exactly what we have been doing in our managed accounts. Rebalancing is a critical component of investment management, and after such a powerful run up in equities it's a good time to have an asset allocation discussion with your advisor.

Surviving and learning from the tough times, and adapting to what the market is currently giving you is the way to survive, and survival is our goal.

***Soft spoken with a broken jaw
Step outside but not to brawl and
Autumn's sweet, we call it fall
I'll make it to the moon if I have to crawl***

As always, be careful out there.

Chris Wiles, CFA



Where Trust is Earned

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