FORTIS FINANCIAL
GROUP

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Dear Clients and Partners:

The markets continued their strong performance in Q2 2024. Bonds, once again struggled to create a positive return (total return equals interest plus the change in the value of the bonds):

Equities 1H24

YTD

	Value	Blend	Growth
Large	6.6%	15.3%	20.7%
Mid	4.5%	5.0%	6.0%
Small	-0.8%	1.7%	4.4%

Bonds 1H24

	Yield		Return
U.S. Treasuries	6/30/2024	12/31/2023	2024 YTD
2-Year	4.71%	4.23%	1.10%
5-Year	4.33%	3.84%	-0.42%
TIPS	2.08%	1.72%	0.70%
10-Year	4.36%	3.88%	-2.03%
30-Year	4.51%	4.03%	-6.20%

Source: JP Morgan

Last quarter we said:

On the equity side two themes have continued:

- ***Growth Leads****: Once again Growth has outperformed Value. After significantly underperforming in 2022, Growth has led the way for over a year*

- ***Large Cap Leads****: Large Cap has continued to outperform Mid and Small Cap.*

Eventually, as we have seen, almost every large company runs into significant issues. The list of the largest companies from even 20 years ago is drastically different from today. But, critically, the ones that have replaced them are better, larger, stronger businesses. AI is highly likely to disrupt many businesses, but the ones that replace them will likely be even better. And they are likely to be Large Caps. And they are likely to be Large Cap Growth companies. This would play into continued Large Cap out-performance.

This thesis continued to play out in Q2. Things likely went "too fast, too soon" resulting in hyper-outperformance of Growth vs. Value, but, longer term, we believe this will continue.

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AI "Bubble"

There is an old market maxim that "a bubble is simply a bull market where one has no position!" This certainly feels true for today given how many people love to talk about how the market is being driven by just a few stocks. NVDA of course is the primary media talking point. It is true that NVDA is leading the market higher, and it is true that it is a significant portion of the market's return. To understand just how much, here is a breakdown of the Russell 1,000 (1,000 largest stocks in the US) performance for Q2:

Russell 1,000 Individual Stock Contributions QTD

Ticker	Name	Sector	Market Cap (bn USD)	Price	QTD % Chg	Russell 1,000 Contribution: Share of Move (%)	Russell 1,000 Contribution: Percentage Points of Move
MSFT	Microsoft Corp	Technology	3,365.72	452.65	7.59	13.43	0.45
AAPL	Apple Inc	Technology	3,283.03	212.99	24.21	36.29	1.21
NVDA	NVIDIA Corp	Technology	3,050.15	124.08	37.32	47.74	1.59
GOOG	Alphabet Inc	Comm. Svcs.	2,300.07	185.55	21.86	23.33	0.78
AMZN	Amazon.com Inc	Cons. Discret.	2,058.95	194.51	7.83	8.31	0.28
META	Meta Platforms Inc	Comm. Svcs.	1,318.04	512.89	5.62	3.94	0.13
BRK/B	Berkshire Hathaway Inc	Financials	880.94	407.00	-3.22	-1.65	-0.06
LLY	Eli Lilly & Co	Health Care	863.96	910.39	17.02	7.13	0.24
AVGO	Broadcom Inc	Technology	738.57	1,599.13	20.65	7.18	0.24
TSLA	Tesla Inc	Cons. Discret.	629.61	196.29	11.66	3.70	0.12
JPM	JPMorgan Chase & Co	Financials	571.95	201.82	0.76	0.25	0.01
V	Visa Inc	Financials	547.32	262.65	-5.89	-1.92	-0.06
WMT	Walmart Inc	Cons. Staples	546.00	67.58	12.32	3.38	0.11
XOM	Exxon Mobil Corp	Energy	515.43	114.91	-1.15	-0.30	-0.01
UNH	UnitedHealth Group Inc	Health Care	447.71	493.18	-0.31	-0.08	0.00
MA	Mastercard Inc	Financials	411.60	442.01	-8.21	-2.09	-0.07
PG	Procter & Gamble Co/The	Cons. Staples	393.25	165.01	1.70	0.37	0.01
ORCL	Oracle Corp	Technology	386.32	141.36	12.54	2.45	0.08
COST	Costco Wholesale Corp	Cons. Staples	377.11	850.50	16.09	2.96	0.10
JNJ	Johnson & Johnson	Health Care	350.89	145.82	-7.82	-1.69	-0.06
HD	Home Depot Inc/The	Cons. Discret.	338.63	342.88	-10.62	-2.28	-0.08
MRK	Merck & Co Inc	Health Care	328.81	128.20	-2.84	-0.54	-0.02
BAC	Bank of America Corp	Financials	306.95	39.60	4.43	0.75	0.03
ABBV	AbbVie Inc	Health Care	298.41	169.82	-6.74	-1.23	-0.04
NFLX	Netflix Inc	Comm. Svcs.	294.88	675.36	11.20	1.67	0.06
					25 Largest	**151.09**	**5.03**
					All Other Members	**-51.09**	**-1.70**
					Russell 1,000	**100**	**3.33**

Source: Bespoke Research

The total return for the Russell 1,000 in Q2 was around 3.33%. The 25 largest companies produced a 5% return and the other 975 produced a negative 1.7% return. That 5% return is also primarily comprised of the top five stocks within the top 25 stocks. NVDA accounts for nearly half of the overall Russell 1000's return.

The question is whether this is a significant problem. It is certainly true that if the market gets narrower (i.e., less stocks are going up) eventually there will be a correction. If it gets really narrow, there can be a sharp move down. There is a saying in the markets that the "generals get shot last." In other words, generally the best and largest stocks (NVDA, MSFT, etc.) go down last.

It is worth taking a step back and thinking about this narrative. Should the market be led higher by a bunch of smaller businesses, or should it be led by the largest and best businesses the world has ever seen? Within that group of the best businesses, should it be led higher by what is the most important business currently (NVDA), in the most important technology breakthrough (AI) in a very long time? In our opinion, the answer is very clearly yes.

NVDA should be leading the market higher. It is growing its earnings at triple digit growth rates from a very large base. That doesn't make this a mania or a stock market bubble or anything else. AI is real. If, say the Industrials and Health Care were leading the market higher that would not make any sense. It is absolutely the case that the revenue side for the businesses creating the AI will need to be determined. While it is possible we will end up in a bubble, for the businesses leading the way (NVDA, AVGO, MSFT, GOOG, etc.) we are nowhere near what we would consider bubble territory.

This is confirmed by the data. Here is where the "AI Leaders" are trading (note many have different fiscal year ends and therefore we used the closest periods):

	Price / Earnings			Earnings Growth		
Ticker	**2024**	**2025**	**2026**	**2024**	**2025**	**2026**
NVDA	45.9	34.3	29.6	108%	34%	16%
AVGO	34.2	27.1	23.6	14%	26%	15%
MSFT	34.3	29.1	25.2	13%	18%	16%
GOOG	24.4	21.6	18.8	30%	13%	15%

Source: Fortis (Factset)

As can be seen above, while current P/E ratios are elevated, given the growth profiles of these businesses we would not consider this bubble territory. In fact, GOOG, is likely cheap given its importance (a feature of the consumer facing portion of GOOG's business). Looking at 2026 it is clear however that the analysts have no idea how this plays out longer term. Effectively everyone is marked to 15-16% earnings growth. Where those numbers start to pencil out likely determines where they trade over the shorter-term (one year). In other words, they will have to "prove it," but we aren't starting from bubble territory.

What is a Business / Group of Businesses (Index) Worth?

There are a lot of factors that determine business value, but in the end it comes down to the amount of cash that will be generated in the future. To take this one step deeper a business is actually worth a combination of the amount of cash that will be distributed (dividends) and the amount of cash that will be generated from the amount of capital retained in the business. This retained capital is referred to as "Invested Capital."

When we look at stocks, we look at the changes in earnings over a given period (how much is the company growing) and we compare that to the total amount of earnings generated over that same time-period. This creates a Return on Invested Capital or ROIC.

Below is a look at the market indexes. These indexes are simply a collection of businesses like the S&P500 being the largest 500 publicly traded businesses in the US. We broke out the ROIC by market index, added in the annual dividend and compared that to the Total Actual Return for the index over the 2019-2024 time period:

2019-2024	ROIC	Dividend	Total ROIC + Div	Total Actual Return	Difference
Large Cap - US	6.64%	1.20%	7.84%	14.45%	6.61%
Mid Cap - US	6.12%	1.44%	7.56%	7.89%	0.34%
Small Cap - US	5.07%	1.38%	6.45%	7.37%	0.91%
International	4.20%	2.78%	6.98%	6.42%	-0.56%
Emerging Markets	1.98%	3.21%	5.19%	3.00%	-2.19%

Source: Fortis (Factset)

Outside of US Large Cap and Emerging Markets (each discussed below) the indexes are appreciating generally in-line with the amount the underlying businesses are generating on their capital (ROIC) plus the dividend. This is what we would expect.

Large Caps

The Large Cap return is greatly in excess of the dividend and the ROIC. This is explained by the growing multiple that is being applied to the earnings. In 2019 the multiple was around 18x earnings. It is currently around 22x 2024 earnings. This 22% increase in valuation multiple (the P/E ratio) applied over 5 years explains the majority of the "Difference".

As we discussed in our prior letter, while we think this might be somewhat excessive, future performance from higher multiples really comes down to whether earnings growth will justify that higher multiple. AI is absolutely a transformative technology. There will certainly be revenue growth opportunities and cost efficiencies captured by the Large Caps, the question is how much. However, if they are trading around a 20% premium to historical figures that is at least partially justified. It would actually be somewhat odd if we did not have some kind of premium to historical multiples when a new transformative technology is being adopted.

Emerging Markets

Emerging Markets' total return is markedly lower than Large Cap's. The Emerging Market's index price is the same price as 2007. That is 17 years of trading at the same price. The only return earned over this period has been the dividend. In fact, Emerging Markets are still below their all-time highs from late 2007.

Looking deeper into the countries which are included has a lot of relevance here:

Emerging Markets

Country	%
China	28%
India	22%
Taiwan	19%
Brazil	6%
Others	25%

Source: Fortis (Morningstar)

China's representation at 28% of the index is the biggest driver. One of the largest and longest trading ETFs for China is FXI. FXI is trading at the same price as 2006 and 60% below its 2007 highs.

Brazil is similar, trading at 2006 prices and over 70% below its 2007 highs.

India is up multiples from 2007 prices and Taiwan is up around 90% from 2007. However, these have not been able to offset the impact of China. That China is still 28% of the index despite being down this much shows the relative size of it historically.

Therefore, the Emerging Markets under-performance is easily explained. The forward performance is, of course, harder to ascertain.

Looking at the top 10 businesses in the Emerging Market index is instructive:

Emerging Markets	**Country**
Taiwan Semi	Taiwan
Tencent	China
Alibaba	China
Reliance Industries	India
HDFC Bank	India
Hon Hai Precision	Taiwan
China Construction Bank	China
Infosys	India
Mediatek	Taiwan
Tata Consultancy	India

Source: Fortis (Morningstar)

This is, generally, a very good group of businesses. However, the composition is nowhere as strong as the US Top 10 companies due to a number of factors:

- Taiwan Semi, one of the most important businesses in the world is located in Taiwan and therefore cannot achieve a multiple that reflects the quality of its business due to geopolitical risk
- Tencent and Alibaba are amazing businesses that are not allowed to be for political reasons
- Infosys and Tata would be the equivalent of a business like Accenture being in the top 10 largest companies in the US. ACN is around the 40th largest company in the US. In other words, while these are good businesses, they are still nowhere near as good as a Top 10 US business
- There are two banks in the top 10 stocks. JPM is the 11th largest in the US and BAC is the 23rd largest. Once again, very good but not great businesses

The combination of these facts means that the index cannot currently produce the same type of ROIC that the US does. There is no reason that it cannot one day. However, with the current constraints in place politically, especially in China, it is likely a large ask for Emerging Markets to get the ROIC up.

International

International (primarily Europe, Japan, South Korea, Australia, Canada) also materially lags behind the US in ROIC. A similar exercise for the top 10 stocks is also revealing (compared to the US here):

US	**International**
Microsoft	Novo Nordisk
Apple	ASML
Nvidia	Samsung
Alphabet	Nestle
Amazon	Toyota
Meta	Shell
Berkshire	Astrazeneca
Eli Lilly	SAP
Broadcom	Novartis
Tesla	Roche

Source: Fortis (Factset)

Once again a very good group of businesses. Comparing the operating margins (EBIT, how much a company earns (E) for every dollar of sales before (B) interest (I) and taxes (T)) and the 2024 projected earnings growth is instructive and explains the ROIC and multiple differential:

	US			International	
Company	**EBIT Margin**	**NTM Earnings Growth**	**International**	**EBIT Margin**	**NTM Earnings Growth**
Microsoft	45%	20%	Novo Nordisk	45%	24%
Apple	31%	8%	ASML	31%	-5%
Nvidia	66%	108%	Samsung	14%	10%
Alphabet	31%	30%	Nestle	17%	3%
Amazon	10%	58%	Toyota	11%	34%
Meta	33%	36%	Shell	14%	1%
Berkshire	13%	11%	Astrazeneca	33%	13%
Eli Lilly	34%	116%	SAP	23%	-5%
Broadcom	59%	14%	Novartis	37%	27%
Tesla	8%	-22%	Roche	33%	6%
Average	**33%**	**38%**	**Average**	**26%**	**11%**

Source: Fortis (Factset)

The top 10 US and International businesses have fantastic EBIT margins. However, US margins are still substantially higher. Growth for the top 10 businesses in the US is more than three times International. This helps explain the much higher International dividend. There are simply not as many opportunities for reinvestment at high rates of return and therefore the dividends paid are higher. This is also a function of the composition of the indexes (much less Tech internationally and much more banks, industrials, etc.).

Summary

In summary, the US indexes should be valued at higher multiples than International and Emerging Markets. This statement is based on facts around the types of returns that can be generated by the businesses, which is driven by the actual companies in each index.

We have traditionally over-weighted US Large Cap vs. International and Emerging Markets for this very reason. We would note that starting multiples do matter and the pricing of International and Emerging

Markets still warrant some investment. That being said, being selective on these securities is important and we will discuss this more in future letters.

Conclusion

We continue to believe that AI is a critical new technology that will reshape the world. The likelihood that it takes longer than expected and that we have a lot of bumps along the way is very high. As we continue to study overall portfolio improvements, we will share these and potentially adjust portfolios as appropriate.

We look forward to speaking with you all soon.

Regards,
Your Fortis Team