

July 2023



The Passionate Investor

2Q2023 Market Review and Commentary

Market Review *

- Equity markets generally **outperformed** fixed-income markets with the S&P 500 rising 8.74% (including dividends; +16.89% YTD) and the Barclay’s Capital U.S. Aggregate Bond index falling 0.084% (+2.09% YTD).
- Small caps **underperformed** large cap stocks (S&P 500) as the Russell 2000 small cap stock index returned +5.21% (+8.09% YTD).
- Growth **outperformed** Value during the quarter and full year (as determined by the S&P 1500 broad market index which includes large, mid, and small capitalization stocks).
- International or developed, non-U.S. equity markets **underperformed** U.S. markets in both U.S. dollars (MSCI EAFE**: +3.22%; +12.13% YTD) and in local currency terms (+4.56%; +12.56% YTD).
- The MSCI Emerging Markets Index **underperformed** developed, non-U.S. equity markets (international) in both U.S. dollar (+1.04%; +5.10% YTD) and local currency terms (+1.85%; +5.76% YTD).
- Most U.S. market sectors were generally positive during the quarter. Technology (+17.20%; +42.77% YTD), Consumer Discretionary (+14.58%; +33.06% YTD), and Communication Services (+13.06%; +36.24% YTD) stocks were most distinguishable given their strength. Utility (-2.53%; -5.69% YTD) and Energy (-0.89%; -5.52% YTD) stocks were notable given their weakness.
- High yield bonds rose 2.02% during the quarter (+5.23% YTD). The U.S. corporate bond sector fell 0.40% during the quarter (+2.90 % YTD). 10-Year U.S. Treasury yields climbed from 3.54% at the beginning of the quarter (3.87% at the beginning of the year) to 3.74% currently.
- The Japanese Yen fell relative to the U.S. dollar (-8.60%; -9.54% YTD), while the Euro (+0.42%; +2.23% YTD) and the British Pound (+2.82%; +5.69% YTD) both rose versus U.S. dollar during the quarter.

* Unless otherwise noted, performances stated above reflect data provided by Standard and Poor’s, Russell Investments, MSCI, and Barclay’s Capital.

** The MSCI EAFE Index is a large capitalization, developed market benchmark that tracks non-U.S. or international equity markets.

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Tim Hai, CFA®, CAIA®
CIO and Sr. Portfolio Manager

“Risk is not inherent in an investment; it is always relative to the price paid. Uncertainty is not the same as risk. Indeed, when great uncertainty – such as in the fall of 2008 – drives securities prices to especially low levels, they often become less risky investments.”
 — Seth Klarman

Company Description

Belleros Capital Management actively manages direct stock portfolios on a fully discretionary basis for institutional clients. Our primary goal is to help them outperform their benchmarks by exploiting short-term market inefficiency through a long-term investment strategy that produces investment portfolios that are differentiated in nature and is concentrated in its number of holdings. The strategy seeks to invest in the stocks of quality companies at a price that is sufficiently below our calculation of its intrinsic value. Additionally, the strategy is all capitalization in nature but tends to have a small and mid-capitalization bias that we believe is secular in nature.

Market Commentary

The S&P 500 continued its strong push forward in 2023, rising a heady 8.74% on top of last quarter’s 7.50% gain (+16.89% year-to-date (“YTD”). The index has reached bull market status¹ after climbing +22.77% since its October 2022 lows. Despite the gains, many investors are lamenting the index’s lack of “breadth” that has only benefited a handful of its largest participants that also happen to be tech-related in nature (please read below for a more in-depth discussion on this topic). Although the S&P 500 index is considered by many investors to be a complete U.S. stock market proxy, most professional participants generally understand it to be only a subset (albeit a majority) of a larger opportunity set of stocks that vary in size. Whereas the S&P 500 includes the stocks of the largest companies, it does not have exposure to or reflect the impact of small or mid-sized companies that complete the universe of stocks available in the U.S.

S&P 500 – Trailing 12-Month and 2Q2023 Performance



Source: FactSet

¹ When stocks collectively rise more than 20% from their most recently reached lows.

Market Commentary...(Cont.)

By comparison, the stocks of small companies as represented by the Russell 2000 index rose a more modest (but still attractive) +5.21% during the quarter, +8.09% YTD, and only +10.55% since its October 2022 lows. Similarly, growth stocks of all sizes outperformed their value stock counterparts during the quarter.

International stocks generally trailed domestic stocks and emerging market stocks trailed those in developed countries. Rising interest rates generally continued to suppress bond prices², pushing some investors into higher yielding sectors. Treasury bond yields climbed higher as the Federal Reserve increased interest rates for a tenth consecutive time (before instituting a pause late in the quarter). Longer-term bonds continued to offer lower yields relative to their respective short-term offerings in a situation known as an inverted yield curve (please click [HERE](#) for more information on yield curves). The U.S. dollar weakened relative to most other currencies not named the Japanese yen.

Bad Breadth

As alluded to above, the recent strength in the stock market is not as robust as it would seem. The S&P 500 is a large capitalization³ index, and its constituents include the stocks of some of the country's largest companies. The S&P 500 has experienced stunning performance in the year's first two quarters. But that strength has not been similarly experienced by other segments of the U.S. stock market. The stocks of small and mid-sized companies have lagged relatively and have had uneven performances from quarter to quarter. Additionally, the strong performance of the index's top companies has failed to be shared by its smaller and more numerous constituent companies. A stock market rally is generally deemed to be healthy (lasting and less prone to a negative price correction) when it is robust and widely participated in across most market segments. We don't speculate what may or may not happen in markets. However, we would not be surprised if volatility creeps higher as the market tests the strength of the recent bull market.

² Bond prices are inversely related to interest rates. Bond prices fall as interest rates rise and vice versa.

³ Market capitalization is a measure of a company's size and refers to the number of its outstanding shares (stock) multiplied by its share price.

"In the short run, the market is a voting machine but in the long run, it is a weighing machine."

— Benjamin Graham

Investment Philosophy

Market Efficiency (or Inefficiency)

Stocks are inherently volatile assets due to the sheer number of participants involved, the diversity of their motives, and the wide range of emotions they employ. Stocks are frequently prone to excessive volatility when emotions particularly run hot. We believe this excessive volatility is a sign of short-term stock market inefficiency. However, we believe the stock market is more efficient over the long-term as rational investment behavior reasserts itself. Similarly, excessive volatility causes the market prices of stocks to deviate from their intrinsic values.

As time progresses, the market prices of stocks generally return to their intrinsic values. We believe that stock market inefficiency as represented by excess volatility is exploitable and represents an opportunity for profit. In our experience, excessive volatility can and does extend to all manner of companies and stocks. Even the best companies and their stock can be affected by stock market inefficiencies and come to exhibit excess volatility, creating exploitable investment opportunity for the astute investor.

“We steer clear of the foolhardy academic definition of risk and volatility, recognizing, instead, that volatility is a welcome creator of opportunity”
 — Seth Klarman

Investment Philosophy

The Main Source of Risk to Long-term Investors

Belleros Capital Management believes that the investment community’s definition of risk as volatility is inappropriate and generally does not apply to all participants. Although the effects of volatility can be particularly disastrous to investors that have near-term income or liquidity requirements, long-term investors can and should be less constrained by it. As opposed to gambling or speculation, we believe that investing is by definition a long-term strategy.

We believe that stock market volatility is a source of investment opportunity for long-term investors, especially when it is excessive. Investors with a strategy to benefit and exploit stock market inefficiencies and excessive volatility should therefore concern themselves with (and try to avoid) greater risks such as a permanent loss of capital, the risk of outliving one’s wealth, or the failure to meet their long-term investment and retirement goals.

The Lucky Seven

Microsoft shocked the technology sector (and broader stock market) earlier this year when it discussed the promise of generative artificial intelligence (“generative AI”) and its investment in ChatGPT (a generative AI technology) creator OpenAI. Simply put, generative AI potentially offers technology capable of replicating work that is otherwise performed by humans. The promise of generative AI sent the stock of a handful of the S&P 500’s largest constituents higher as investors sorted out which companies would be most likely to benefit from the technology. The table below lists the ten largest participants in the S&P 500 (by size). The median performance for the ten largest stocks in the index was 18% in the second quarter and 46% over the entire first half of the year. The first (and largest) seven companies (eight stocks; the Alphabet exposure is listed twice due to its separate shares classes) which have the potential to benefit from generative AI have a median performance of 22% in the second quarter and 52% over the first half of the year (not shown below). The top ten stocks in the S&P 500 index accounted for 30.5% of the index and (especially the top seven stocks) have made up [a strong majority of the index’s performance](#) for most of the year.

Top Ten Stocks in the S&P 500 Index

Rank	Weight	Ticker	Company Name	2023	
				2Q Perf	1H Perf
1	7.72	AAPL	Apple Inc	17.79	49.72
2	6.81	MSFT	Microsoft Corp	18.38	42.66
3	3.13	AMZN	Amazon.com Inc	26.21	55.19
4	2.82	NVDA	Nvidia Corp	52.31	189.54
5	1.91	GOOGL	Alphabet Inc Cl A	15.4	35.67
6	1.90	TSLA	Tesla Inc	26.18	112.51
7	1.71	META	Meta Platforms Inc Class A	35.41	138.47
8	1.66	GOOG	Alphabet Inc Cl C	16.32	36.33
9	1.64	BRK.B	Berkshire Hathaway Inc Cl B	10.44	10.39
10	1.20	UNH	Unitedhealth Group Inc	2.11	-8.65
Median				18.09	46.19
Mean				22.06	66.18
Total Exposure				30.50	

Source: Morningstar and FactSet

The Less Fortunate

For comparison purposes, below is another table listing the next ten largest members in the S&P 500 (by size). The median performance for the next ten largest stocks in the index was 8% in the second quarter and slightly less than that over the entire first half of the year. Importantly, the table shows significantly lower performance for the next ten largest companies in the S&P 500 index during the 2nd quarter and over the first half of 2023. It is also notable that most of the next ten stocks belong to companies outside of a technology-related sector or industry. The next ten stocks in the S&P 500 index accounted for 9.95% of the index. Together, the top 20 stocks in the index accounted for over 40% of the index by market weight - a considerable concentration of value in just a few of the index's largest constituents.

Next Ten Stocks in the S&P 500 Index

Rank	Weight	Ticker	Company Name	2023	
				2Q Perf	1H Perf
11	1.17	XOM	Exxon Mobil Corp	-1.35	-1.17
12	1.16	JNJ	Johnson & Johnson	7.6	-4.92
13	1.14	JPM	JP Morgan Chase & Co	12.49	10.11
14	1.03	V	Visa Inc Class a Shares	5.54	14.75
15	0.99	LLY	Eli Lilly & Co	36.92	28.94
16	0.97	AVGO	Broadcom Inc	35.94	57.11
17	0.96	PG	Procter & Gamble Co	2.69	1.39
18	0.89	MA	Mastercard Inc A	8.39	13.46
19	0.85	HD	Home Depot Inc	6.04	-0.22
20	0.79	MRK	Merck & Co. Inc.	9.19	5.42
Median				8.00	7.77
Mean				12.35	12.49
Total Exposure				9.95	

Source: Morningstar and FactSet

“Wide diversification is only required when investors do not understand what they are doing.”
 — Warren Buffett

Investment Philosophy

Diversification (or Not)

Belleros Capital Management believes the idea of portfolio diversification is counter-intuitive and works against our active management goals. The idea of diversification is meant to limit the impact of stock market volatility. We believe stock market volatility represents an investment opportunity that is exploitable. Therefore, limiting the opportunities we seek to exploit would seem rather perverse. Diversification is a sliding scale. Too little and you risk putting all your eggs in too few baskets; too much and your portfolio and expected return mimics the broader stock market (index).

We believe excessive diversification (in addition to high investment-related fees) is a main contributor to poor active management performance relative to passive/index investing. We believe investors who seek excess returns above and beyond what one could expect to receive from the broader stock market should choose an investment manager that minimizes fees and seeks to differentiate their investment portfolio to ward off the indexing-like characteristic of diversification.

“Owners of stocks, however, too often let the capricious and often irrational behavior of their fellow owners cause them to behave irrationally as well. Because there is so much chatter about markets, the economy, interest rates, price behavior of stocks, etc., some investors believe it is important to listen to pundits – and, worse yet, important to consider acting upon their comments.”
 — Warren Buffett

Please [contact us](#) to learn more about our investment strategy and how we try to add value for our clients.

The S&P 500 Equal Weight index

As mentioned above, the S&P 500 is highly concentrated among its largest constituents due to a weighting scheme that rewards stocks with the highest market capitalization. The S&P 500 Equal Weight Index (the “Equal Weight” index) is less well known than its similarly named sibling. As the name aptly describes, it is allocated such that each constituent in the index is assigned an equal weight. The result is an index with more diversification benefits and that is more easily comparable to the typical stock portfolio as managed or held by many investors (professional or otherwise). Whereas the top 20 stocks in the standard S&P 500 account for 40% of the index’s total market capitalization, the weighting of the same top 20 stocks in Equal Weight index is only 0.20% (one fifth of a percent) per stock or 4% in total (for all 20 stocks). As an example of the difference, although shares of Apple account for nearly 8% of the standard S&P 500 index (twice that of the combined top 20 stocks in the standard index alone), its weight is considerably less in the Equal Weight index. Further, performance between the two indices can diverge starkly over the short-term because of their different weighting schemes (but converging somewhat over the long-term). The Equal Weight index’s performance (see table below) is considerably less over the past quarter (+3.99%), YTD (+7.03%), and since the October 2022 lows (+15.89%).

S&P 500/S&P 500 Equal Weight Comparison

Index	2023		Since
	2Q Perf	1H Perf	13-Oct-22
S&P 500	8.74	16.89	22.77
S&P 500 Equal weight	3.99	7.03	15.89

Source: FactSet

Buy the Hype?

Given the potential for generative AI, some might wonder if there is enough potential in the technology to lure us into making a purchase of such (potentially) transformational technology. While we do not like to close the door on our options (we like more rather than less), the situation would have to be right. The new technology would have to be easily understood by us and we freely admit that we are not yet comfortable or well versed enough on the potential of generative AI. We generally like the stocks of companies whose business models are proven and easily understood. We also generally do not like to go out on a limb and pay for growth, let alone a growth premium, especially for nascent technology. And this is what generative AI is at this point. The future is very murky and unclear to us. We have no idea who the winners will be in the future. More importantly, we have no idea if the technology is viable (profitable) or when it will become so. Valuations are also a priority for us and not an afterthought (see below).

Valuations Always Matter

Investing in a pre-revenue/earnings company is not a possibility. A more realistic scenario would involve investing in a pre-existing company (mature) that has the potential to benefit from the technology. This company's stock price would have to be selling at a considerable discount to intrinsic value. Regardless of the reason for this discount, whether it is fundamental or macro-economically driven, if the price of the stock has fallen enough such that its growth potential is materially selling below its worth (or ideally not priced in at all), we would consider it. Again, we would stress that this company would more than likely be an existing, mature business with pre-existing qualities that make it attractive without regard for its aforementioned growth prospects. We find scenarios like this to be more probable (and potentially profitable) for us relative to pure speculation. (Please click [HERE](#) or refer to the columns or appendix of this newsletter to review our investment philosophy and strategy)

What A Tough Business

Market prognostication is a difficult profession to be in and probably doubly so in recent times. As an example, many (if not most) prognosticators have been projecting a potential recession in the U.S. for almost two years now because of high inflation and the Federal Reserve's response to it (higher interest rates). Higher interest rates and the rate at which they were increased (as the thought goes) should have led to slowing economic activity in the form of weaker employment and moderating business activity. It follows then that stocks were also predicted by many to falter as sales and earnings (expectations) for businesses (public and private) fell. The economy has been surprisingly resilient with stronger than expected employment and GDP. Company sales and earnings haven't contracted as much as expected. And, the stock market hasn't followed through on last year's weakness. Indeed, the stock market's strength has been an event that most if not all prognosticators were unable to forecast. Prognosticators have held views that have covered the spectrum between bearish and bullish views. However, we would suspect that many of them could not have guessed the impact of generative AI on the stock market over the past six months.

Closing Remarks

Other professional investors or news outlets have referred to our Lucky Seven stocks as the Magnificent Seven stocks. Although the stocks (most of them at least) do perhaps belong to companies deserving of that title, we prefer “lucky” based on the performance they’ve experienced in 2023. The basis for that performance has largely been aspirational and revenue and profits from the generative AI technology which propelled their shares have yet to be realized. We daresay most investors or market observers probably did not anticipate generative AI or the ultra-narrow bull market in the S&P 500. We are comfortable calling them lucky given the “hype” premium built into their stock prices and the lack of quantifiable and tangible fundamentals.

We sympathize with those who seek their own fortune by fortune telling to others. But we prefer fundamental investing. We understand that luck is always a factor in both professions – good or bad. And we fully understand the difficulties of stock investing. “Investing” is inherently long-term and adding value is not usually a short-term endeavor. Importantly, it is not easy and certainly not guaranteed. Discipline is required and we always try to adhere to our philosophy and strategy – even in the toughest and most arduous of times. The stock market experience is not linear and difficult markets occur from time to time. But they come with the territory, and we would not have it any other way. That is because we understand that the most difficult moments represent the best opportunities. It’s our job to take advantage of them when they occur, no matter the market climate. We thank you for your trust and patience as we continue to persevere. Have a great summer!

“There’s no doubt that hard work, planning and persistence are essential for repeated success...But even the hardest workers and best decision makers among us will fail to succeed consistently without luck.”

– Howard Marks

Investment Strategy

We seek to exploit stock market volatility in the short-term through a long-term, active investment management strategy that seeks to purchase higher **quality** stocks with sustainable competitive advantages and economic moats, and at prices below our calculation of intrinsic value (otherwise known as “value investing”). These characteristics help us defend against what we believe is **the biggest risk in investing: a permanent loss of capital**. In addition, we intend to show our discipline and conviction in our investments by employing a concentrated portfolio mandate that is differentiated and allows us to focus on only the best investment candidates available. Further, we seek to show our conviction through our portfolio weighting scheme which skews exposure to the best investment candidate.

- Active investment management
- Long-term investing
- Seek higher quality opportunities
- Value investing
- Minimizing permanent losses of capital
- High conviction
- Invest with confidence
- Disciplined approach
- Volatility is an opportunity
- Concentrated stock portfolio
- Differentiated from the index

“Risk is not inherent in an investment; it is always relative to the price paid. Uncertainty is not the same as risk. Indeed, when great uncertainty – such as in the fall of 2008 – drives securities prices to especially low levels, they often become less risky investments.” — Seth Klarman

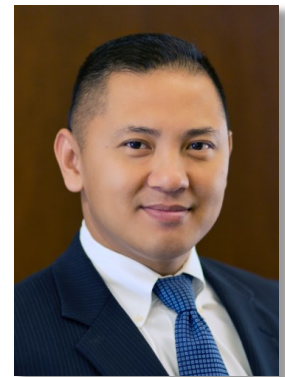
“We don’t have to be smarter than the rest. We have to be more disciplined than the rest.” — Warren Buffett

Biography

Tim Hai, CFA®, CAIA®

Chief Investment Officer and Senior Portfolio Manager

- 26 years of experience in the investment industry
- 12 years of equity portfolio management experience
- 6 years experience overseeing public equity and fixed-income assets for a \$10 billion multi-employer pension plan
- 8 years exp. manager research and due diligence
- M.B.A. - Loyola College of Maryland, 2000
- B.S. Finance – University of Maryland, College Park, 1996



Tim has 26 years of diversified investment experience that includes the research and direct investment management of stocks and bonds for high net worth and small business clients. Additionally, Tim has experience in manager research and due diligence, having helped oversee and manage a \$10 billion institutional pension fund. Tim had direct oversight of the pension fund’s equity and fixed-income investment portfolios that were managed by outside investment managers. Tim had specific oversight over the pension fund’s \$1.2 billion concentrated managers program that sought to extract value add from some of the country’s best investment managers through a mandate that required high conviction and a limited number of stock positions.

Tim received his B.S. in Finance from the University of Maryland, College Park and his MBA from Loyola College of Maryland. More recently, he also completed coursework in international investing and currency management with the Oxford International Investment Programme at the Said Business School at the University of Oxford, United Kingdom. Tim holds the Chartered Financial Analyst (“CFA”) and Chartered Alternative Investment Analyst (“CAIA”) designations. He is a member of the CFA Institute and the CFA Society Washington, DC. He is also a member of the Washington, DC Chapter of the CAIA Association.

Disclosures

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*Past performance may not be indicative of future results. Therefore, no current or prospective client should assume that future performance of any specific investment or investment strategy (including the investments and/or investment strategies recommended or undertaken by Belleros Capital Management, made reference to directly or indirectly by Belleros Capital Management, or indirectly via a source to an unaffiliated third party), will be profitable or equal the corresponding indicated performance level(s). Different types of investments involve varying degrees of risk, and there can be no assurance that any specific investment will either be suitable or profitable for a client or prospective client's investment portfolio. Historical performance results for investment indices and/or categories generally do not reflect the deduction of transaction and/or custodial charges, the deduction of an investment management fee, nor the impact of taxes, the payment of which would have the effect of decreasing historical performance results. **For Professional Use Only***