M1 CAPITAL
INVESTMENT MANAGEMENT

Everyone Is Saying How Expensive Nvidia Is – Market Commentary

The month was marked by relatively severe underperformance by South Africa relative to Emerging Markets. The local market returned -3.9% in ZAR terms but +8.4% in Rand depreciation saw the USD return decline to -11.4%. For the year-to-date to the end of May South Africa has now returned -10.3% in USD terms vs the MSCI Emerging Markets Index return of +1.1%.

Internationally (read the US), the rebound rally gathered strength. The Nasdaq returned +7.7% vs the S&P 500's +0.4%. For the year-to-date the Nasdaq stands at +30.8% vs the S&P 500 at +9.4%. As can be expected the MSCI Growth Index has returned +19.7% vs the MSCI Value's -1.9%.

We note however that this rally is not broad-based and has been driven by the largest Tech shares. Apple, Microsoft and Amazon have returned +36.4%, +36.9% and +43.5% respectively. This explains most of the strong Nasdaq and MSCI Growth outperformance.

The various market returns are summarised in Table 1 below.

Table 1. South African and global equity returns (USD) for May 2023 *

	May-23	YTD 2023
FTSE/JSE ALSI (ZAR)	-3.9%	4.5%
FTSE/JSE ALSI (USD)	-11.4%	-10.3%
MSCI World	-1.0%	8.5%
MSCI EM	-1.7%	1.1%
MSCI Value	-4.6%	-1.9%
MSCI Growth	2.4%	19.7%
S&P 500	0.4%	9.4%
Nasdaq 100	7.7%	30.8%

*Total return indices, Source: Factset

When US Treasury yields and the Fed Funds rate began to rise in early 2022, a preponderance of voices began to proclaim that the era of low rates was over. The world had changed permanently and irreversibly, it was implied, and the multi-year trend of ever-declining rates and ever-rising valuations was over. Most of these voices appeared to be of professed Value managers, and the tone (subject to interpretation of course) seemed primarily to be one of relief and "I told you so". Certainly this was understandable, given the multi-year outperformance of Growth and the corresponding underperformance of Value shares, and indeed of US stocks vs the rest of the world.

We are not so sure the world has changed. Certainly not irreversibly so. Not that we make macro decisions in our investment process but as immersed participants we pay attention. Our view, for what it is worth, is that inflation could well still turn out to be transitory and appear as a blip on a longer term chart in a few years' time. There are risks as usual. The sharp decline in CPI is due to lower Energy prices, while Core CPI is more stable but still declining. We feel the second-order effects of energy costs finding their way into the rest of the economy take longer but are also subject to reversal if oil prices rise. Yet the initial driver of inflation – a sharp increase in money supply - now negative and, effectively, unprecedented, is not receiving nearly as much attention as it should. The follow-up driver – supply chain disruptions - are close to disappearing. So whether conditions have changed permanently remains to be seen, but overall we are sceptical of the above-mentioned voices' assertions.

Is this commentary not meant to be about Nvidia?

Indeed. Nvidia is a now-prominent US chipmaker. Initially making graphics chips and now powering AI-related applications including ChatGPT. Towards the end of May it released good quarterly results and projected quarterly revenues to rise to USD11bn, about +55% higher than the prior year. The company certainly appears to be a major beneficiary of the AI hype and its stock has risen to match. The price rose +24.4% on the day of the results release, and has continued rising since, returning +36.3% in total for May. It briefly entered the select club of USD-trillion companies on May 30th.

The reason we began this commentary with a discussion of inflation and interest rates is that following Nvidia's strong price performance, it seemed similar voices from multiple corners almost instantaneously materialised to declare "Look how expensive it is!!". A now-famous quote of Scott McNealy[1], former CEO and co-founder of Sun Microsystems, explaining the implications of a 10x stock price to sales, is widely-invoked. The quote can be found at the end of this article.

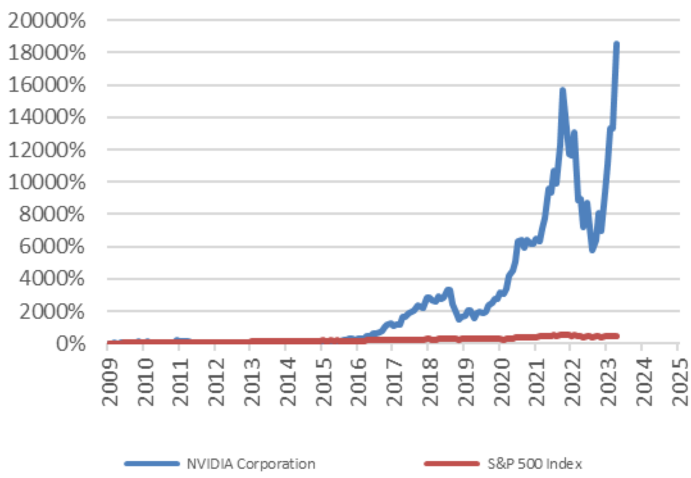
Why are we discussing Nvidia at all?

We are not here to argue with Mr McNealy. The argument makes sense, of course, though every discussion in investments, we believe, carries nuances. We do point out first, however, that the M1 Capital Global Equity Prescient Fund has held Nvidia stock since its inception in August 2016. Over this period Nvidia has returned +2 722.3% vs the S&P 500's +93.2%. We do not particularly feel any compulsion to write about how expensive it is (others are doing a good enough job already) but instead are rather pleased at the return it has generated as well as the attention it has attracted. It is of course one of many positions in the Fund.

So is it expensive?

It certainly seems so. By most valuation metrics it is quite expensive, especially now. At the time of writing Price to Earnings is 209.4x and its Price to Sales is 37.5x (refer to Scott McNealy) – quite impressive. Chart 1 below presents Nvidia's returns relative to the S&P 500 and provides some context.

Chart 1. Nvidia cumulative return vs the S&P 500



From the Chart we can see that Nvidia first started to materially outperform the S&P 500 around 2016. It then declined quite sharply towards the end of 2018 during the previous rate-hiking cycle and attempted Quantitative Tightening for those who remember (that sharp decline appears as a blip today and we wonder if we were supposed to have sold then on valuation measures, or because interest rates were rising at the time).

From the end of 2018 the stock then rose 8-fold as the QT reversed and the world entered the Covid crisis in early 2020. It then declined -63% in 2022 as the latest interest rate tightening cycle began, before once again rising 3x to its current euphoric high.

Why do we hold Nvidia?

Valuation forms one perspective of our assessment. The growth rate has also certainly been impressive. We were however more interested in more mundane considerations and financial metrics – consistency of revenue, cash flow etc. We hold the share because we see some security in underlying operating performance as opposed to the attractions of its growth rate or how cheap or expensive it is. We also note that the company is certainly not recession-proof (we still have to see a Tech stock which is).

Where to from here and should we not be selling?

The problem with valuation is that performing the required calculations is a relatively simple exercise. The difficulty lies in the quality of the inputs. And here a company can surprise on the upside, as happens to have happened with Nvidia, as well as the downside.

The Financial Times ran the following headline[2] on June 7th:

Nvidia's rally forces money managers to play catch-up

Funds lightened exposure to chipmaker before bullish AI sales forecast made it a $1tn company

Underweight positions in tech stocks have led some fund managers to underperform this year © FT montage/Getty

The article discusses how "Big money managers missed out on the rally in Nvidia and spent the past two weeks catching up, racing to amass shares of the US company that has become a go-to bet on artificial intelligence.

State Street, Fidelity, Amundi, Ameriprise's Columbia Threadneedle and Loomis Sayles all cut positions in Nvidia in the first quarter of 2023 before a powerful rally pushed the chipmaker's valuation to $1tn, securities filings showed. An analysis by Goldman Sachs shows they were far from alone: mutual funds were broadly reducing exposure to Nvidia in early 2023, making the stock one of their most underweight positions.

But fund managers have been loading up again, according to interviews with traders at Wall Street banks. Mutual funds and hedge funds have been scrambling to top up their positions in Nvidia, other AI-linked growth stocks such as Advanced Micro Devices and semiconductor exchange traded funds."

If we were 100% focussed on valuation we may well have joined some of the funds described above i.e. selling low and buying high. A value approach, surprisingly but not often discussed, can lead one to do this. Actually we expect that from the current lofty levels the price could well decline, perhaps steeply so. We are not however particularly concerned by this. The stock has been volatile and we expect this to continue. Holding it from 2016 however has been the correct decision and has produced good returns. We do not control the stock price or the emotions which drive it. Neither does the company's management. As long as the company performs well in its core businesses we are happy to continue holding.

1. Scott McNealy quote

   "…2 years ago we were selling at 10 times revenues when we were at $64. At 10 times revenues, to give you a 10-year payback, I have to pay you 100% of revenues for 10 straight years in dividends. That assumes I can get that by my shareholders. That assumes I have zero cost of goods sold, which is very hard for a computer company. That assumes zero expenses, which is really hard with 39,000 employees. That assumes I pay no taxes, which is very hard. And that assumes you pay no taxes on your dividends, which is kind of illegal. And that assumes with zero R&D for the next 10 years, I can maintain the current revenue run rate. Now, having done that, would any of you like to buy my stock at $64? Do you realize how ridiculous those basic assumptions are? You don't need any transparency. You don't need any footnotes. What were you thinking?"

2. https://on.ft.com/42B51Cm