The Views from the “Mag 7” Deck Have Been Spectacular, but it is Getting Very Crowded on That Side of the Boat

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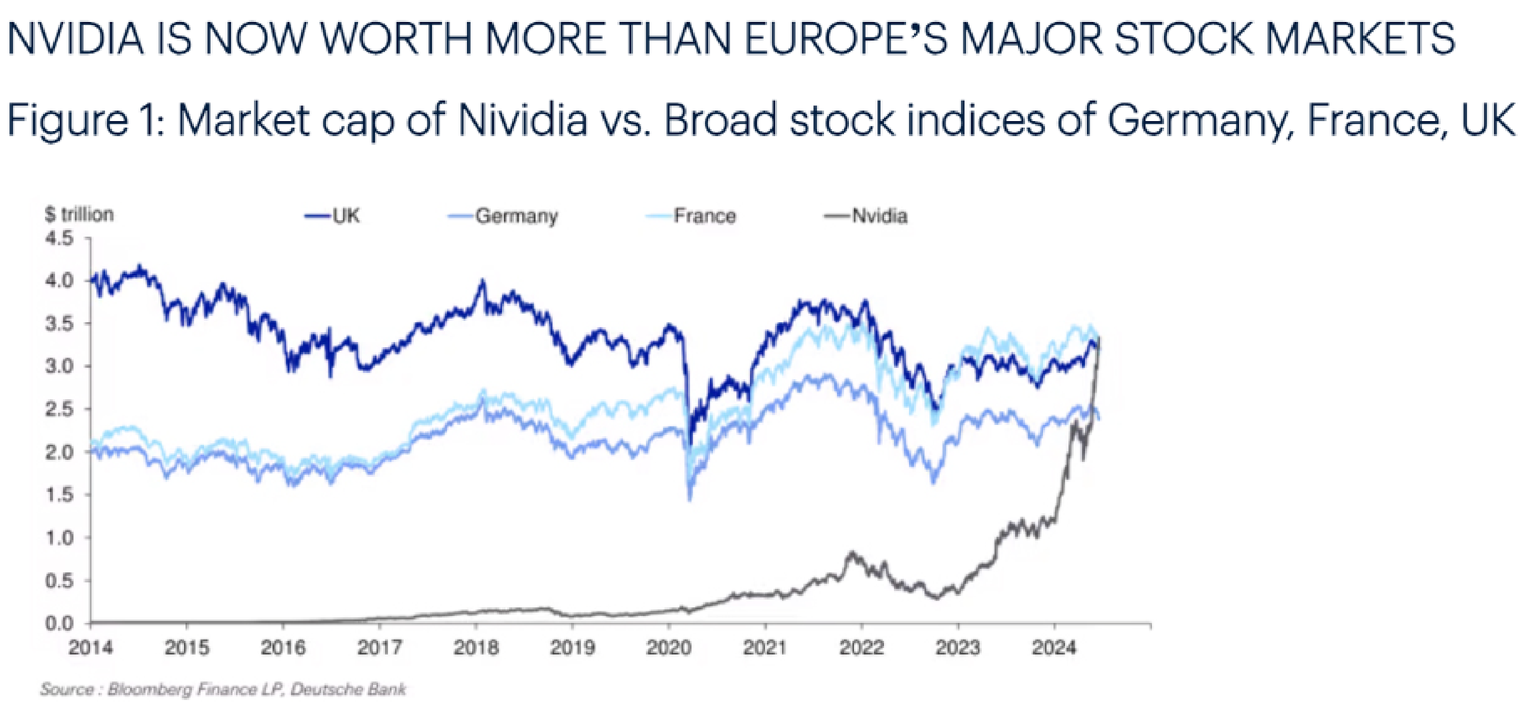
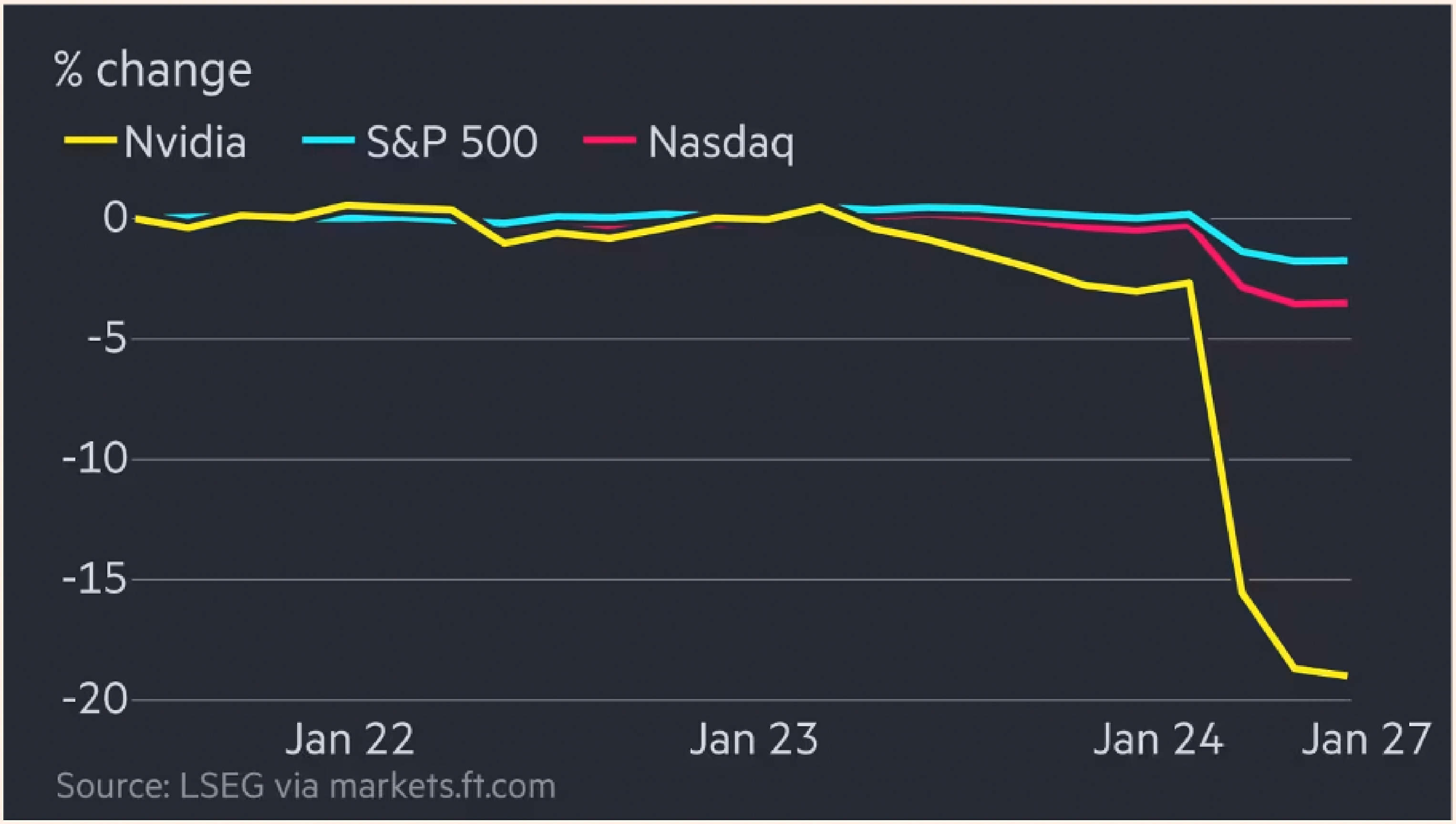
Are the S&P 500 and Nasdaq 100 indices at risk of being an Artificial Intelligence (AI) "house of cards?" AI has been the dominant investment theme over the last two years following the initial introduction of Chat GPT in late 2022. Since that time, AI applications and development spending has propelled Nvidia (NVDA) stock and the other so-called "hyperscales" such as Microsoft (MSFT), Meta (META), Oracle (ORCL), Alphabet (GOOGL), and Amazon (AMZN) to new highs and lofty valuations.

The conventional thesis that has propelled these mega-cap technology hyperscalers companies has been that NVDA had both durable and dominant market share in terms of designing and selling advanced Graphic Processing Unit (GPU) semiconductor chips used in AI server computers, which were being aggressively purchased by the hyperscaler mega-cap technology cloud computer companies to compete in the rapidly expanding AI marketplace.

The following chart from ICIS's Paul Hodges at the end of June 2024 clearly illustrates, using the stratospheric advance of NVDA stock since the end of 2022, just how pervasive and powerful the AI theme has been since Chat GPT was initially introduced:



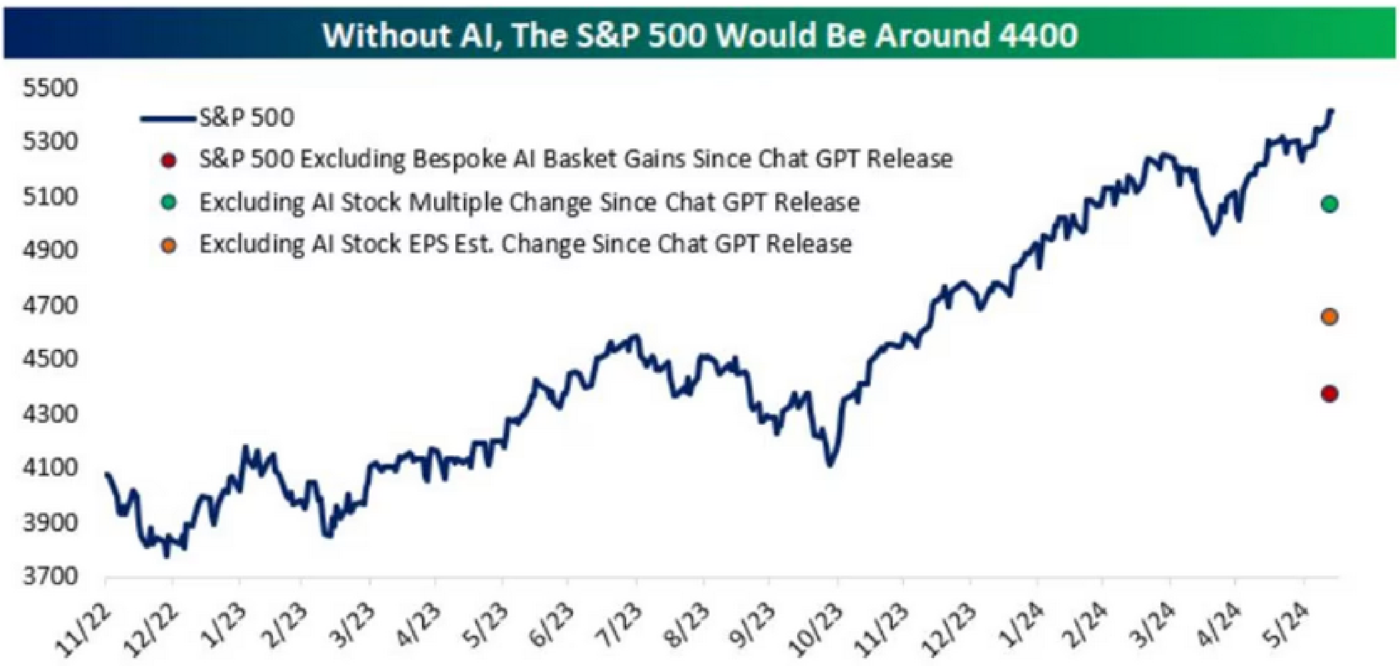
This chart from mid-2024 showed Nvidia at a stock price that translated to a market capitalization of roughly $3.6 trillion. This was approximately the market capitalization of Nvidia at the end of trading on Friday, January 24th, the day before the stock saw its market cap decline by over $600 billion on the news that Chinese company Deep Seek announced that its AI system outperformed the best system from the U.S. hyperscales without using Nvidia's most advanced chips and at a development and energy consumption cost much lower than comparable AI systems developed by U.S. companies. See the following chart capturing the percentage sell-off of NVDA stock, Nasdaq, and the S&P 500 following the Deepseek announcement:



© A chart of the share price percentage fall of Nvidia compared with the S&P 500 and Nasdaq over the past four trading days

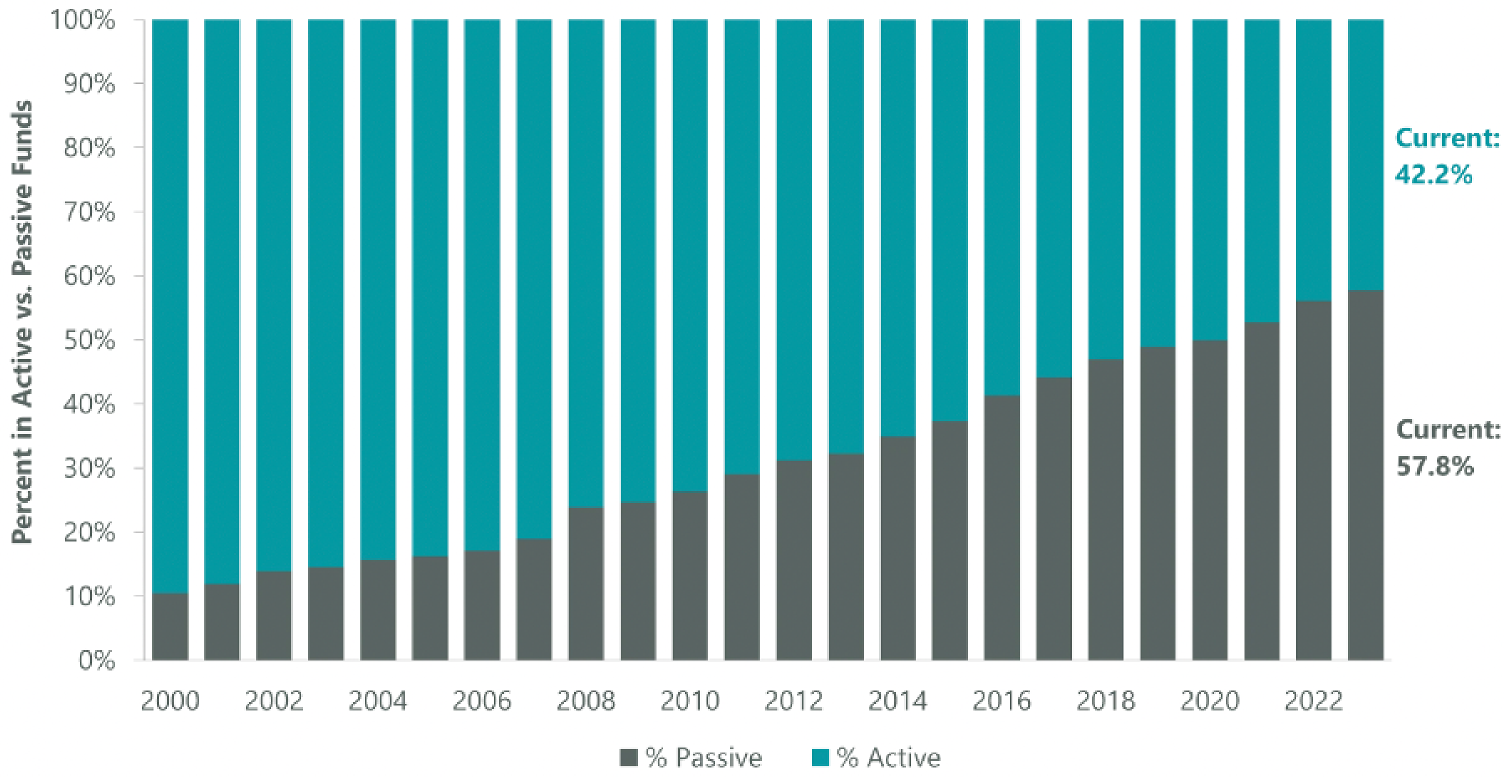
Some Seven Summits Capital managed accounts hold NVDA stock. However, NVDA stock is underweight overall, and the January 27 AI sell-off had minimal influence on our portfolios. We have been wary of the "house of cards" risk with the "AI trade" that has so substantially driven market returns since the introduction of Chat GPT in late 2022. See the following segment of a June 14, 2024 article by CNBC titled The S&P 500 would be nearly 20% lower without AI mania, says this chart.

The collective market cap of Bespoke's 30 AI stocks is up 101% since ChatGPT's November 2022 release, equal to roughly 1,050 points for the S&P 500. "In other words, without the gains in AI stocks, the S&P 500 would be around 4,370, 19% lower than today, all else being equal," they said in a note to clients on Thursday, offering the below chart:



As I have stated and written many times over my career, no one can consistently and successfully time equity markets. All a professional investor can do is recognize market imbalance and valuation risks and be informed by historical market data to take non-market timing precautions to address the recognized risks. Having managed investment portfolios for over 27 years, I have seen and managed through many periods of equity market imbalances and unusually high valuation multiples. I have also seen the increasing evolution of the professional investment management industry that has resulted in professional money management moving from seeking to identify and take advantage of market pricing inefficiencies to simply overtly or covertly mimic the composition of the major broad market indices. The following chart is from a Franklin Templeton paper published on March 18, 2024, titled Historic Concentration Forges Emerging Asset Class in U.S. Growth Equities:

Exhibit 4: Majority of Assets Reside in Passive Strategies

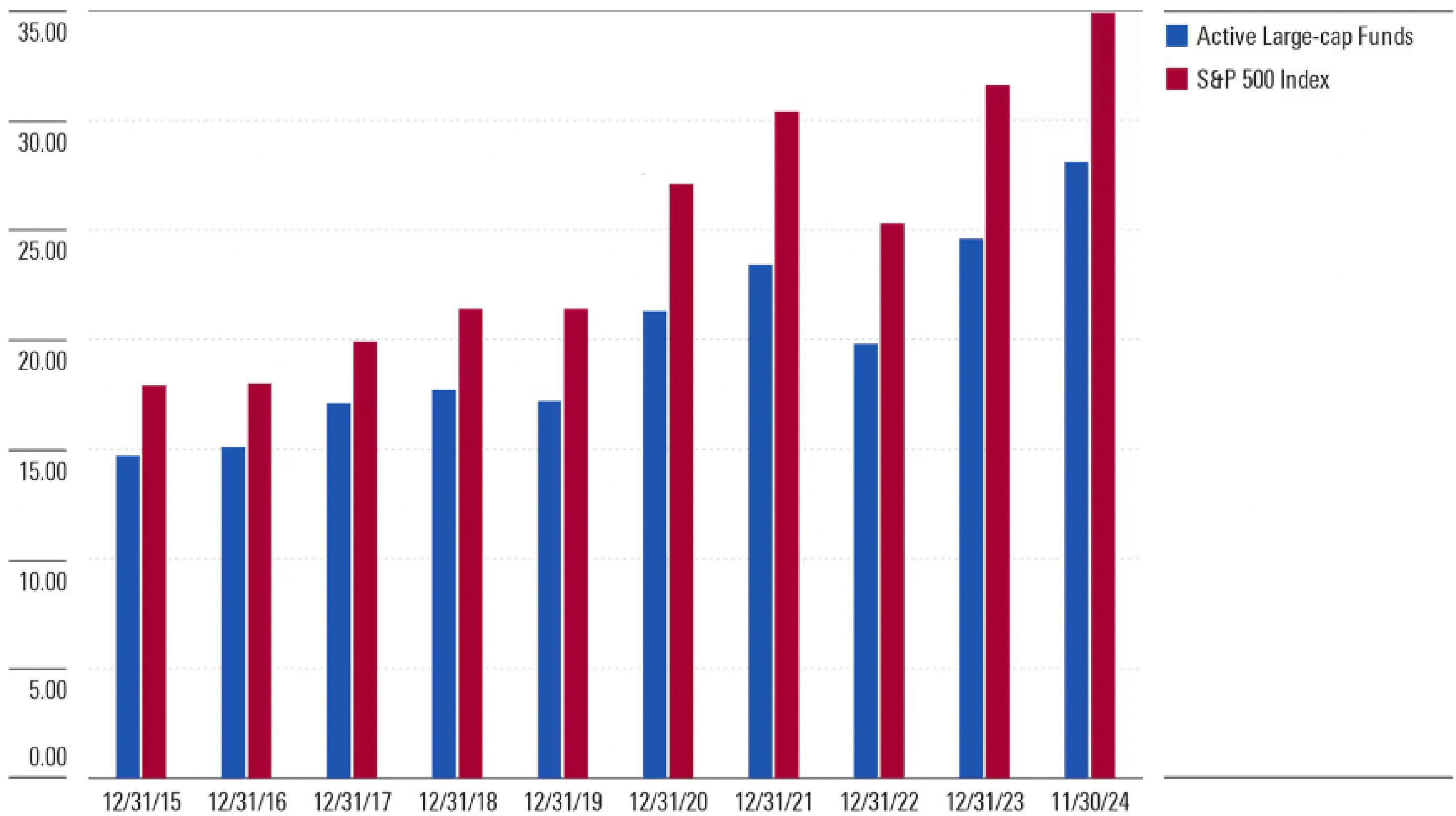


Source: Strategas, based on an analysis of data from the Investment Company Institute. Assets represent US equities only. As of December 31, 2023.

Since I have been managing investment portfolios professionally spanning the entire time frame shown in the chart above, I can speak to how the market has changed over that time because of the increasing prevalence of passive investing. This chart does not show that within the "active" fund category, a meaningful number of those funds, particularly those in the very popular large-cap category, look and act more like passive index funds than not. See the illustration below from Morningstar published January 8, 2025, titled Pot Kettle Black: Active Funds and Index Concentration Problem.

% Weight in Top 10 Holdings: Active Large-Cap Funds vs. S&P 500 Index

Active large-cap funds' aggregate weights in their top 10 holdings have resembled the S&P's.



> To summarize, as a group, the active large-cap funds concentrated in their top holdings to a similar degree as the index. Moreover, as the index's concentration fluctuated, so did the active fund composite's, and its active share barely budged throughout this 10-year span.

Many are advertised as active large-cap mutual funds and ETFs today, but when you look under the hood, they have a very similar concentration in the same 7-10 stocks that now make up over 30% of the S&P 500's weighting. This practice is known in the industry as "closet indexing." A hyper-focus on short-term benchmark comparison has increasingly taken over the industry over the same period that passive investing has become much more dominant. To try to compete with passive indexing, many active managers have decided that they cannot afford to have their portfolios deviate significantly from their assigned benchmarks. Thus, they have consciously chosen to manage the portfolio in a way that they can still call themselves an active manager and charge active manager level fees, but at the same time hold many of the top positions of their assigned benchmark as their funds' top positions to largely tether their funds' performance to that of the index. Therein lies the risk that I see in the overall market. For those old enough to remember watching Louis Rukeyser's Wall Street Week show on PBS or various other investment shows during the late 1980s through early 2000, you will recall the legendary investor Jim

Rogers, co-founder with George Soros of the Quantum hedge fund. Jim is quoted as saying about the markets and investors. "When **everybody** is on one side of the boat, you should go to the other."

Right now, as I have illustrated above, the boat/market analogy has never been more glaring. This imbalance has persisted longer than most people who pay attention to such matters would have predicted, and it could continue to persist this way for a while longer. We will never try to time the capsizing of the boat or the significant shift that would bring the markets into better balance, but through our investment choices, we attempt to try to enjoy the views on the crowded side of the boat while staying as far from the crowd as we can get.

Overall, we were very pleased with the equity performance of our accounts in 2024 and with largely avoiding the Nvidia (NVDA)/AI flash crash on January 27th. I know that this January commentary is being published much later than usual. I will attempt to get back on the more normal middle-of-the-month schedule in February.

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Exchange-traded funds (ETFs) are sold by prospectus. Please consider the investment objectives, risk, charges, and expenses carefully before investing. The prospectus provides a balanced analysis of the investment risks and benefits. Read it carefully before you invest.

- The Standard & Poor's 500, or simply the S&P 500, is a stock market index tracking the performance of 500 large companies listed on stock exchanges in the United States. It represents the stock market's performance by reporting the risks and returns of the biggest companies. Investors use it as the benchmark of the overall market, to which all other investments are compared.
- The NASDAQ Composite Index is a large market-cap-weighted index of more than 2,500 stocks, American depositary receipts (ADRs), and real estate investment trusts (REITs), among others. Along with the Dow Jones Average and S&P 500, it is one of the three most-followed indices in US stock markets. The composition of the NASDAQ Composite is heavily weighted towards information technology companies.
- The Dow Jones Industrial Average (DJIA), also known as the Dow 30, is a stock market index that tracks 30 large, publicly owned blue-chip companies trading on the New York Stock Exchange (NYSE) and the Nasdaq.
- The Russell 2000 index is an index measuring the performance approximately 2,000 small-cap companies in the Russell 3000 Index, which is made up of 3,000 of the biggest US stocks. The Russell 2000 serves as a benchmark for small-cap stocks in the United States.

The Russell 2500 Index measures the performance of the 2,500 smallest companies in the Russell 3000 Index, with a weighted average market capitalization of approximately $4.3 billion, median capitalization of $1.2 billion and market capitalization of the largest company of $18.7 billion.

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