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Arrowside Capital Q3 2023 Commentary

Performance Summary

Q3 2023 Performance	Q3 '23	YTD '23	Since Inception
Arrowside Innovation	-2.6%	23.9%	27.9%
MSCI World	-3.8%	9.6%	20.0%
Relative Performance	1.2%	14.3%	7.9%
Arrowside Small Cap Growth	-4.8%	12.3%	12.3%
Russell 2000 Growth	-7.5%	4.7%	4.7%
Relative Performance	2.6%	7.6%	7.6%

Note: Arrowside Innovation inception was October 1, 2022. Arrowside Small Cap Growth inception was January 1, 2023. Strategy and benchmark "Since Inception" returns begin on those dates, respectively.

Market and Economic Commentary

The third quarter of 2023 showed losses in global equity markets. Investors were focused on inflation, the Federal Reserve, and corporate earnings.

During the third quarter, inflation reversed its downward trajectory and increased in percentage terms from a two-year low of 3.0% in June, to 3.2% in July, and 3.7% in August. Much of the increase in inflation month on month could be explained by an increase in fuel prices. The Federal Reserve has been very aggressive in hiking interest rates to slow inflation and took more action in the quarter, raising rates by 25 basis points in July to a target of 5.25-5.50%. At that time, they signaled that there is still significant inflation risk that may merit further increases going forward. In September, Chairman Powell and company decided to hold rates at the same level.

Artificial Intelligence (AI) remained in focus for investors, as many are still trying to figure out the short- and long-term implications for companies and the overall economy. All eyes were on large technology companies like Microsoft and Alphabet, who both showed strong results, especially for cloud-based services. There was wide anticipation for Nvidia's second quarter results following their stronger than anticipated first quarter results. Nvidia has become a bellwether for AI spending as the leader in semiconductor chips that go into very powerful computers that power AI. Their results again surpassed analysts' expectations, but there was so much optimism going into the release of results that almost all technology companies saw their share prices pull back in September.

Corporate earnings were mixed for the second quarter. Many technology companies reported good results, and many companies talked about some slowing in demand, especially from year ago levels. Companies in the consumer sector were a bit softer than expectations. Many cited a decrease in demand due to higher interest rates.

The banking sector has not produced major negative headlines since the issues in the Spring. The sector has laid off thousands of employees to right-size and become more efficient. Companies such as Goldman Sachs and Wells Fargo have been particularly notable in their downsizing plans this past quarter.

Broad-based indices have been stronger this year largely due to much better than market returns for the largest companies, led by big tech. The disparity in returns for the largest companies over the companies in the small cap indices is the largest in quite some time. So far this year, the largest tech companies have posted solid results and are widely considered to be the biggest near-term beneficiaries of AI.

Innovation Update

We closely follow what is going on with the most innovative companies that can affect the future. This past quarter, there was a lot of activity among the big players in AI. Open AI had a busy quarter, releasing numerous updates to their popular ChatGPT. Users are now greeted with prompts and speech options are now a part of the consumer's way of interacting with the service. Other players that offer Large Language Models (LLMs) were also very busy. Google added image upload capability to Bard. Apple indicated that they have been working on a framework, code named Ajax, to build LLMs and are deciding how to release it to consumers. In addition, private company Anthropic raised more than $1B and announced a partnership with Amazon.

Innovation Fund holding Nvidia had a very active quarter as well. On the product development and release side, the company announced that their Super Grasshopper Superchip will enter production in Q2 of 2024. The new combo chip will combine a Graphics Processing Unit (GPU) and a Computer Processing Unit (CPU). This has the potential to be game changing, as each AI system requires a CPU and a GPU. The GPU space is dominated right now by Nvidia and adding more functionality to their processors could enable them to solidify their lead for a while. The company also announced a handful of venture investments in the quarter to expand the AI ecosystem that they want to be a leader in. Financing for AI, and specifically Generative AI, continued to be robust in the period.

As AI gains in popularity, it is also attracting the attention from regulators. In the third quarter, the FTC demanded certain records from Open AI. In addition, the larger players made voluntary AI governance pledges to the White House. We expect more to come in this area in the next year and beyond.

For those that want to understand a bit more about AI, we recommend the 60 Minutes interview with Geoffrey Hinton, known as the "Godfather of AI," which can be found easily on YouTube. The interview covers a lot of ground, including how AI works, what its applications can be, and the possible downsides.

Also in the quarter, there were continued signs of pulling back in the Crypto segment. Some large investment funds, such as Temasek, have pulled back from Crypto investments all together due to regulatory uncertainty. The pullback also includes layoffs from some of the well-known companies such as Binance, who laid off more than 1,000 employees in the quarter.

Apple reported results for the second quarter and said on their call that the US smartphone market has been in decline the last few quarters.

Investment Cycle Thoughts

It is our belief that we are headed for a soft landing for two reasons. First, there are pockets of the economy that continue to do quite well despite the steep increases in interest rates. The areas where there have been decreases in demand have been less severe than one might anticipate going into a deep recession. Second, we are believers that the economy is in the midst of having a smoother line up and to the right over the longer term, driven by efficiencies in the entire system from the use of technology. Back a few decades, there were more steps in the global economic system, more distribution steps, more human prediction on supply and demand and less capital available for growth. These have all improved over the 20 years, and even more dramatically over the last 10 years. Technology, and specifically the Internet, have shortened the distribution steps and increased transparency on issues such as price and inventory, both of which are key to effectively managing a business.

It is our belief that this will make economic cycles less pronounced. There will still be cycles in our view, but they will be more nuanced. This will mean less boom and bust, which for the global markets should provide opportunities for those willing to be patient.

It is our view that the current level for global markets is in the range fairly valued to slightly undervalued, depending on one's time horizon. In the short term, we have witnessed a lift in markets after the sharp selloff in 2022. Many of the best performers in the last year have had a combination of strong fundamentals and an expansion in the company's valuation. In many cases, it was simply the continuation of good results that instilled some confidence, enabling the valuations to lift toward previous highs.

There are many companies and pockets of the market that have seen little recovery. Areas of note would be the Small and Midcap sections of the market. These areas have endured the punishment of the selloff in 2022 and have not seen the bounce in 2023 that the larger companies have, namely in technology. If the economy experiences softness but not a deep recession, it is our belief that Small and Midcap are very undervalued areas and should experience outperformance in future periods.

We believe that we have been in the bottoming process for some time and are now starting to turn toward a period where the overall market will better mirror the growth in corporate earnings and cash flow. We have mentioned in prior commentaries that there appears to be more dispersion among individual companies and their share prices, driven by actual fundamental results. We believe a higher cost of capital and an economy that will struggle to grow rapidly, will be with us for some time. This is very good news for those that rely on individual company and stock selection to drive returns, both on an absolute and relative basis.

Outlook

Our belief is that there will be a massive increase in demand for computing power over the next decade as AI becomes more mainstream. The early indication from leaders such as Nvidia as well as tech giants like Microsoft, Meta, and Alphabet is that capital spending will be quite strong for computing infrastructure. This will be for AI directly as well as for cloud computing, where the greatest broad-based demand is likely to come from. We plan to share more about our view about this theme, as well as communicate more about areas where we see the most opportunity.

We believe that the narrow rally that has buoyed much higher returns for big tech will broaden out to midcap and small cap in the next 18 months. We see a normalization of business activity after the initial reaction to the steep climb in interest rates. Many companies in the economic food chain adjusted in the early part of the tightening cycle, which made sense. Now that rates are starting to level out at a higher level, we anticipate this will be modeled into business plans and a more normal pace of economic activity will be witnessed over the coming months.

We are reasonably confident that we have come out of the bottom of this cycle and anticipate a gradual upward trend. We expect some volatility along the way. We also expect the small and mid-cap sectors to start to participate in the market uptrend. To date, the relative outperformance of large cap over mid and small cap can be traced to just a handful of companies. For this to be a more sustained uptrend, we expect the small and mid-cap sectors of the market to begin to outperform.

The pace of rapid innovation remains unabated, with companies introducing exciting new products and services. Our long-term outlook is highly optimistic when it comes to investing in transformative change. As we put the bottom behind us and enter a new bull market, we anticipate excellent investment opportunities to arise. For these reasons, we refrain from timing the market and instead stay invested in the best-in-class companies that drive change, allowing us to look past short-term fluctuations and maximize long-term returns.

We appreciate the trust you have in our philosophy and process. Please do not hesitate to reach out with questions or feedback.

Sincerely,

Tucker Walsh
Managing Partner / CIO

About

Arrowside Capital is a Boston, Massachusetts based investment company focused on investing in innovative companies that have demonstrated financial discipline. The firm was founded in 2022 by Tucker Walsh, who has more than 30 years of experience in investing in small and midsized innovative companies. Arrowside Capital believes that investing in innovative companies creating change builds the most value over time. The firm's rigorous investment process searches for companies that are both innovative and profitable. Companies in the firm's concentrated portfolios have durable competitive advantages, superior margins and returns on capital, and ample reinvestment opportunities. The combination of great conditions, plus great management behaviors produce the most intrinsic value growth over the long-term. Arrowside Capital favors small and mid-cap companies to take advantage of the market inefficiencies resident in these types of companies.

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