ARROWSIDE

Arrowside Capital Q1 2024 Commentary

Performance Summary (as of 3/31/24)

	Q1 2024	Since Inception	+/- Q1 2024	+/- Inception
Arrowside Global Innovation	**9.6%**	**63.1%**		
S&P 500	10.2%	46.5%	-0.6%	16.6%
MSCI World	8.5%	44.5%	1.1%	18.6%
Russell Midcap Growth	9.3%	45.6%	0.3%	17.5%
Arrowside Smaller Cos	**4.3%**	**32.4%**		
Russell 2000 Growth	7.4%	26.5%	-3.1%	5.8%

Note: Arrowside Global Innovation inception is 10/1/22; Arrowside Smaller Companies inception is 1/1/23; performance is net of fees.

Market and Economic Commentary

Global markets showed more strength in Q1, driven by strong corporate earnings. Interest rates remained unchanged, as the Federal Reserve made no changes in the quarter. They signaled that they would prefer to lower rates in 2024, but inflation results have remained stubbornly high.

Much of the excitement in the quarter was again focused on Artificial Intelligence (AI), which has been a front-of-mind topic for many and was a key theme in 2023.

There was enthusiasm for companies that delivered better than expected revenue and profits. This has been a big part of the recovery in markets over the last year plus. Companies that deliver solid results are rewarded with positive results in their stock price and valuation. Those who do not suffer a setback. The focus on profit growth is a switch from the widespread enthusiasm in the 2020/21 period, where all companies that showed growth in revenue became more valuable. Once interest rates rose and the economy reacted, we would have expected a preference shift, which has certainly occurred.

Most of the debate about a “soft landing” or recession has dissipated. Economic data surrounding employment and housing have remained solid to strong. We are in the camp of believing that the economy now has less pronounced swings due to the proliferation of technology and having the internet as the base layer for communications, etc. Technology ubiquity has increased the amount of awareness on the part of consumers and corporations, allowing for more real-time adjustments. This reduces the amount of human emotion in the process, which helps reduce wild swings in the cycle.

Corporate earnings were a bit mixed, but the tone of many management teams was a bit more optimistic. The pandemic began about four years ago, and this period has been unique. Many pockets of the economy experienced either a sharp increase in demand, followed by a slowdown, or a shutdown, followed by a period of recovery. As companies sort through this unusual set of circumstances, they are evaluating customer behavior and investments that are required to be positioned in a more normal period going forward.

Technology companies seem to still be in an adjustment period, as customers are still determining what they need in terms of cloud computing, software applications, and IT services. Consumer companies are still a bit mixed, but some of the better-managed companies are reporting that they are a bit more optimistic about the rest of 2024.

Market returns were similar to the full year of 2023, with the largest companies by market value enjoying better returns. This is consistent with investors' preference for increasing profits now. Many of the largest companies, especially Big Tech, are still growing revenue at a strong pace and have reduced expenses, allowing profits to flow through. The business models for the Big Tech players are as good as any in history, so the narrowness of results makes sense to us right now.

Innovation Update

This past quarter was a busy one for innovative companies. Nvidia posted very strong orders and revenue for the fourth quarter and indicated that the current pace of demand should remain for some time. The company has continued to innovate on the chip side, with a slate of GPU offerings. They also released software that allows individuals and companies to tap AI features in a similar fashion to LLMs (Large Language Models), such as Chat GPT.

Many companies in the semiconductor complex released positively trending results, and those that spoke of positive demand for AI chip solutions, were rewarded with increases in stock prices and valuation.

The crypto market continued to show strength. The much-awaited Bitcoin ETFs began trading, and the large players saw strong inflows in the first few months.

Investment Cycle Thoughts

We believe the economy is on solid ground and does not appear to be in jeopardy of a severe downturn. Over longer time periods, company results drive the returns in the market. In shorter periods, the market can vary in terms of what it values.

Currently, there is a premium being placed on growth, especially growth in profits. This has created a narrowness in the market as well as a broader effect on larger companies enjoying better returns. We believe the market will broaden. But, with interest rates higher than in the recent past and a premium being placed on profitability, we believe that one must be selective to realize positive returns across style categories. There will be excellent opportunities in mid-sized and smaller companies, but broadly speaking, profitability across the mid- and smaller-cap segment is not as strong. So, it could be that there are excellent opportunities in mid – and smaller cap companies, but the category may still have trouble outperforming.

Valuations are not cheap but also not extended. Our valuation work indicates that for our companies in aggregate, valuations are approximately 15-20% higher than long term averages. This indicates that valuations for our type of company are not cheap, but certainly not extended. It is important to notice that companies with lower growth or lower levels of profitability have not seen their stock prices and valuations rebound for the most part. The strongest performers have been the companies that have posted the strongest results, both in terms of revenue growth and increasing profits. Markets are typically due for corrections when there is a broad move that is valuation-driven, waiting for results to come through. This does not seem to be the case now.

Overall, we believe we are in a healthier market. There will be pullbacks, but we think that these will be associated with concerns about near-term valuations, not macro concerns as we enter the next phase.

Portfolio Thoughts

We are still very optimistic about the prospects for our portfolio companies. The areas of the economy that are poised to capture more growth and profits over the next several years remain the same in our minds.

The area with the best prospects resides within the technology sector. We are believers that Gen AI is transformative. As such, we see there being direct winners in the initial stage of growth. Most will be in the semiconductor area, with others coming from application software and security.

We made a small number of trades in the period, adding a few new companies to the portfolios. We eliminated a few companies we had concerns about in the long term. We also did a handful of trims and adds to adjust to outsized movements in stock prices and valuations.

Our positioning continues to be tilted toward companies that will enable technological gains or be power users of advances in technology. AI is next in the progression of technological innovation, and we anticipate that demand for AI-enabled solutions will be very high going forward. This will reward well positioned infrastructure providers in the semiconductor and software industries. Accordingly, our exposure in these areas is high, even within our technology sector exposure. We view semiconductors as new age industrials, except that they can sustain higher rates of growth in revenue and cash flow than other industrial alternatives.

The semiconductor industry has evolved in the last three decades and looks very different from the industry we studied in the 1990s. The industry, while in growth mode, also consolidated. This has set the survivors up for success, as evidenced by the software-type margins and profitability of many of the market leaders. Look no further than Nvidia, whose business model today has more growth and profitability than any company we can find. The industry has a history of being cyclical. We do not see that changing except that we believe that Gen AI and growth in other applications will continue to drive long term growth for the industry. Long-term growth and high profitability are the underpinnings, and this, we believe, sets the industry up for long-term value creation.

Note: Arrowside Capital holds a position in Nvidia.

Outlook

We are optimistic about the intermediate term, and very optimistic about the longer term. This is especially true for innovative companies, such as those with proven business models. Over the long term, company results drive investment returns. Companies that have the combination of growth, robust margins, and the ability to reinvest at high rates of return are in a great position to drive great long-term outcomes.

Higher interest rates have made it more important than ever to have a solid business model, one that can be self-sustaining and utilize its margin and cash flow to make investments to drive future growth.

Markets are now rewarding a narrow set of companies with these traits, and if interest rates remain in this general area, we see this continuing.

We are committed to transparency regarding our thoughts on the market, our positioning, and how we see changes impacting innovative companies. We post regularly on LinkedIn and write a weekly on Substack called The Zen Innovation Investor. Please check these out for more thoughts from us, and please send us any feedback.

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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