ARROWSIDE

Arrowside Capital Q4 2023 Commentary

Performance Summary

Q4 2023 Performance	Q4 '23	2023	Since Inception
Arrowside Global Innovation	17.0%	45.0%	49.7%
MSCI World	11.1%	21.8%	33.2%
Relative Performance	5.9%	23.2%	16.5%
Arrowside Smaller Companies	13.1%	26.9%	26.9%
Russell 2000 Growth	12.5%	17.8%	17.8%
Relative Performance	0.6%	9.1%	9.1%

Note: Since Inception Performance for Arrowside Global Innovation is from 10/1/22-12/31/23 and for Arrowside Smaller Companies is from 1/1/23-12/31/23.

Market and Economic Commentary

The fourth quarter of 2023 showed strong returns across global markets. Investors were focused again on inflation, the Federal Reserve, and corporate earnings.

In the fourth quarter, inflation continued its downward trajectory, with November's reading coming in at a 3.0% annual increase. The Federal Reserve had been very aggressive in hiking interest rates to slow inflation but decided at its two meetings in the quarter to keep rates unchanged at a target of 5.25-5.50%. At the December meeting, Chairman Powell gave investors some hope for interest rate cuts in 2024, and the market responded with a rally into year end.

The debate about whether we are going to have a soft landing, or a recession remains. Much of the economic data to date has suggested that the economy is resilient, but the effects of large interest rate increases take time to work through the economy.

Artificial Intelligence (AI) remained in focus for investors, with the biggest news being the boardroom drama at Open AI in November. This was a wake-up call for many in the AI and Tech community as there was serious debate inside the company about its direction and leadership. Ultimately, CEO Sam Altman returned shortly after being ousted and the company is now poised to do another round of financing at a greater than $100B valuation.

Corporate earnings were again mixed, and the tone of many management teams were muted. There were pockets of good news, and many companies are still setting forward guidance to reflect a slowdown in the global economy.

Many companies had layoffs in the 4th quarter, and layoff announcements have continued in the new year. There is an interesting dynamic occurring, where a handful of technology and consumer companies are in search of talent, while others are shrinking headcount.

Global markets staged a rebound in 2023, led by the outperformance by Big Tech. The largest 7 companies, and weights in the indices, performed much better than the average stock. The average Mega Cap gained 95% in the year, and 77% without Nvidia, who was a newcomer to the Mega Cap category. These returns lifted the indices most heavily tilted toward Big Tech and created a divergence amongst market cap segments not seen in decades.

Innovation Update

This past quarter was a busy one for innovative companies. Open AI grabbed headlines for its Developer Conference, where they introduced many initiatives including the ability to program your own GPTs. They reduced the cost per inference significantly and introduced the concept of a store for GPTs, which should go live in early 2024.

Both Nvidia and AMD reported strong orders for AI chips, and both introduced new processors in a battle to gain market share. As of today, there is a shortage of GPUs, which power current AI systems, and Nvidia maintains a close to 90% share. We also witnessed a decent number of semiconductor companies reporting that inventories are more in line with current demand, while the companies that supply chips to power AI systems are predicting that there will be shortages for quite some time.

The crypto market showed signs of life, and Bitcoin increased more than 160% in 2023. This rise is largely attributed to the anticipation ahead of the launch of Bitcoin ETFs, twelve of which went live in January. In addition, there was also more interest in other coins, such as Ethereum and others as the market shook off a steep decline in 2022.

Investment Cycle Thoughts

We are still in the soft-landing camp for the economy. We continue to believe that the economy is quicker to adjust due to technology ubiquity. The real-time nature of technology enables the economy to anticipate and adjust earlier than in the past. We see the capital cycle turning to being increasingly accommodative in the next few years, but it will not return to the zero-rate environment.

The current level for global markets is in the range of 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 size, strong fundamentals, and an expansion in the company’s valuation. It is important to remember that Big Tech endured a sharp and deep selloff in 2002, and in 2023 recovered only enough to get back to late 2021 levels.

There was broader participation across the market in the fourth quarter, which is a good sign for the short to intermediate term. There are structural issues that are enabling large companies to grow to sizes that we have never seen before. This has to do with technology ubiquity and the way that some of the best companies are built, especially those with subscription revenue. These companies have scale, great cash flows, and strong balance sheets.

We anticipate that the larger companies, especially Big Tech, will continue to grow their businesses and economic value over the next several years or more. Their reinvestment and embedded position create more opportunities for them than in past periods. This has staved off competition and limited opportunities for upstarts. We see this as an issue that investors and allocators will have to deal with in 2024 and beyond. Having said this, we see opportunities across the market cap spectrum, and small and midcap segments of public markets have yet to see the type of valuation lift that the mega caps have from the 2022 bottom.

We have come out of the bottoming process now and are back into a healthier market. There will be pullbacks associated with concerns about near-term valuations, not about macro concerns as we go into this next phase.

Portfolio Thoughts

We are still very optimistic about the prospects for our portfolio companies. Some experienced a slowdown during the year because of the backup in interest rates. Consumer companies such as RH and Yeti in particular reported softness. We expect their outlooks for 2024 and beyond to improve as we move through the year. Others experienced a large pickup in demand due to AI, specifically Nvidia, AMD, and Monolithic Power who all had more demand than they could supply exiting the year. We expect to see a continued surge in demand for AI infrastructure in 2024 and into future years.

In a few cases, we witnessed what we considered to be outsized appreciation and decided to reduce the weight to redeploy into new or existing holdings. This is a healthy process, as we are still owners, but if valuation goes well above the company long-term average, we expect either an inflection higher in revenue growth or muted forward 3-year returns. In Q4, we decided to trim back our position in Fair Isaac (FICO) due to outsized outperformance relative to the growth rate that we believe is achievable over the next several years.

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.

We will be looking for opportunities if volatility returns to markets in 2024.

Outlook

We are optimistic about the intermediate term, and very optimistic about the longer term. This is especially true for innovative companies, those with proven business models. We were all reminded in 2022 and early 2023 about the importance of the balance of growth and business model flexibility. Many companies that were laden with debt found themselves in trouble as interest rates increased. So too were the troubles associated with companies with no cash flow or negative cash flow, as markets dried up for fresh funding. This of course puts a large dent in valuations and some companies are in a rough position, even after a rebound in sentiment.

After a strong rebound year in 2023, we anticipate that there will be some concerns about valuations as we go through 2024, especially around earnings reporting periods. We see this as normal and expect heightened volatility in the first half of the year. We still see opportunities to invest in innovative companies that have proven business models and a history of value creating reinvestment. As we look across the market, we see more opportunity for valuation expansion in smaller and mid-cap companies as mentioned before. We are keeping an eye out for opportunities that could be created by some short-term valuation concerns to either build new positions or add to existing holdings at reduced prices.

The pace of change is very rapid right now. Large companies, like those in Big Tech, are spending feverishly to establish position in AI, and there are also challengers in the private markets going after share. As such, we are very bullish on infrastructure spending, namely for semiconductor companies, the ones that are well positioned for AI spending. We are also very bullish on the software companies that are native to cloud computing and have a strong connection with their customers.

Our thesis for both the short and long term is that Technology Ubiquity is here to stay, and owning the right companies is vital to adding value above market returns. Tech Ubiquity has had an impact on the economy and investing. Companies that have created long-term economic value now make up a large percentage of the indices. Companies can now scale to sizes not seen before and continue to grow at rates that defy prior thinking on the law of large numbers. This adds complexity to investing. It also means that there will be higher volatility than in past periods because technology stocks are more volatile.

Our strategies are managed the same way that we have managed portfolios over the last 20 plus years, except that they have reduced market cap constraints to enable companies that distinguish themselves to continue to add value over long holding periods.

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. It is important to remember that the market rewards companies that grow and produce cash. This combination can be found in innovative companies and those are the companies that we evaluate. If a company meets our high standards, then we plan to own it for a long time.

One new initiative for us was the start of a regular post on Substack called The Zen Innovation Investor. We have had a lot of fun with it, as it is a way to sharpen our thinking and communicate with the community our ideas and thoughts as we go along. We have treated it as a perpetual whitepaper of sorts, where we take on topics that would be reserved for a whitepaper, but in bite sized chunks. We have enjoyed hearing the feedback and especially so when we get some pushback on ideas and thoughts about where the world is going. Past volumes can be found on our website, please take a look and subscribe if you enjoy reading it.

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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