Market Commentary
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English Version

Insigneo Weekly Dispatch

How Big is too Big?

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How Big is too Big?

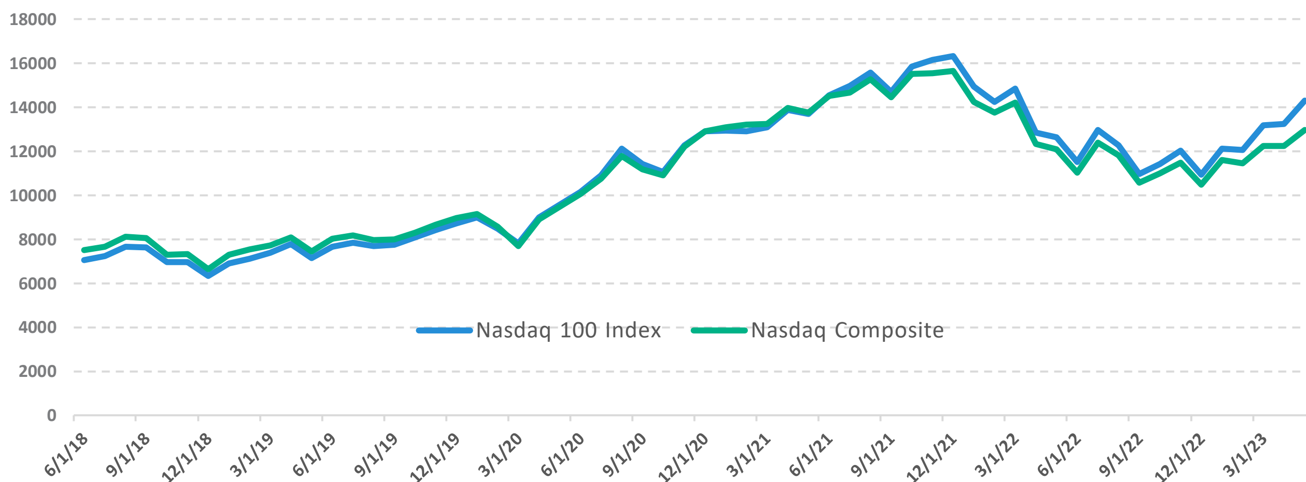
Welcome to the Trillion Dollar Market Cap Club. On Monday, Nvidia briefly became the 9th company to ever break above the $1 trillion market capitalization threshold. The other 8 companies to have achieved this milestone are Apple, Microsoft, Alphabet, Amazon, Saudi Aramco, Tesla, Meta, and PetroChina, although the last three are no longer above this mark. For anybody wondering which company is the largest in the world, it is Apple, with a market cap of $2.79 trillion. To put this in perspective, if Apple were a country, its market cap would fall between the GDPs of France and Italy, making Apple the 8th largest country in the world. Put another way, the combined market caps of Apple, Microsoft, Alphabet, Amazon and Nvidia amount to approximately $9 trillion, larger than the GDP of every country in the world, except for the United States and China. To be sure, we are not arguing that these are bad companies because of their size. On the contrary, many of these are great companies and leaders in their respective industries. What we are saying is that we need to keep things in perspective and be aware of the large run-up in their share prices.

It's hard to argue against the fact that the latest rally in the markets has been led by large cap tech stocks, particularly those associated with Artificial Intelligence. Nvidia (NVDA) is a good example of this trend. The stock is up 175% since the beginning of the year, rising over 40% in the month of May alone, after the company announced better than expected sales and management unveiled new products related

to Artificial Intelligence. As a leading manufacturer of computer graphic processing units, Nvidia has been a strong player in the chip-making industry for decades. Its products, initially used to power high-end video game graphics, expanded to supply data centers used to power anything from company websites to bitcoin. In fact, its data center operations now account for 40% of the company's revenues, and this number is only expected to grow. This is where Nvidia's presence in artificial intelligence comes in. The company has become a full-scale solution provider for generative AI, providing hardware and cloud-based software used to develop AI systems across multiple industries such as fintech, automotive, and healthcare. Revenues are likely to continue growing in the foreseeable future, as demand for AI continues to grow. From a financial perspective, the company appears to be well positioned, with reasonable levels of debt and cash, as well as attractive profit margins and strong free cash flow generation. As we can see, Nvidia is a very good company. However, as we all know, every investment also needs to be viewed through the lens of valuation. The stock currently trades at a forward P/E near 55X compared to its industry peers at 37X. There is no question that Nvidia is the leader in its peer group and should trade at a relative premium. However, a 50% valuation premium to the group average appears high. Nvidia is a great company and will likely continue to prove to be a good investment over time. However, given the large run-up in the stock, we would not chase it at this time and would wait for a lower entry point to consider investing.

Nvidia is not alone in this dynamic. As we know, most of this year's move in the market has been fueled by large cap tech companies, particularly those with exposure to Artificial Intelligence. This is further exemplified when we study various indices in more detail. To this point, let's compare three major indices, the Dow Jones Industrial Average, the S&P 500, and the Nasdaq 100, taking a deeper look into their exposures to technology companies. The Tech and Communication Services sectors comprise approximately 20% of the Dow Jones, 40% of the S&P 500 (including Amazon), and 75% of the Nasdaq 100 (including Amazon). Given the outperformance we have seen in technology companies, it should come as no surprise that the heavier the exposure of these companies in an index, the better its performance. However, the magnitude of the relative outperformance between indices is astounding. Through the first five months of the year, on a total return basis, the Dow Jones was up 0.25%, the S&P 500 up 9.64% and the Nasdaq 100 up 30.79%. The tech-heavy Nasdaq 100 outperformed the tech-light Dow Jones by over 3,000 basis points. This sort of outperformance is unheard of.

If we dig deeper, we see a similar dynamic even when we compare tech-heavy indices. Believe it or not, the Nasdaq 100 and the Nasdaq Composite are two different indices. With an average market cap close to $5 billion, the Nasdaq Composite is comprised of over 2,500 securities across different industries. Approximately 60% of this index is composed of technology-related companies. On the other hand, the Nasdaq 100 is comprised of the top 100 non-financial companies in the Nasdaq Composite, based on market cap. So, the larger the market cap of the company, the larger its weight in the index. Unlike the Nasdaq Composite, the average m arket cap of companies in the Nasdaq 100 is close



Source: Bloomberg, Insigneo. As of 5/30/23

to $130 billion. Additionally, approximately 75% of this index is composed of technology-related companies. Basically, this index is dominated by large cap tech. The chart above examines the performance of both indices over the past 5 years. As we can see, both track each other closely. In fact, the average point-spread between both indices over this period has been negligible, under 500 points. However, let's focus on the most recent end of the graph, encompassing 2023. Here we can see a wide spread between both indices, close to 1,320 points, confirming that big tech has meaningfully outperformed even its smaller cap peers. With history as our teacher, divergences such as this one tend to converge back to normal levels over time. Sometimes over days, weeks, or months, but they do tend to resolve themselves.

Again, to be clear, this is not to say that large cap tech companies are not good investments. Many of these are some of the best run companies in the world and will most likely prove to be great investments over time. Coupled with the advent of artificial intelligence, it is understandable why some of these companies have outperformed their peers. AI is here to stay and the impact it will have on our lives is mind-blowing. Much like during the advent of the internet, many companies will be major beneficiaries of this new technology. However, much like during the internet boom, many companies are also likely to fail. As such, it is important to carry out proper due diligence and not jump blindly into trends. Given the recent outperformance of many of these stocks, we believe that investors' emotions may be getting the better part of them, as they chase these stocks higher. FOMO, or the Fear of Missing Out, is a very

powerful emotion, and can trap even the most seasoned investors. The volume of call options on the Nasdaq 100 is the highest it has been in the last 20 years, and optimism is at risk of turning into euphoria. While we like many of the technology companies involved in this year's tech rally, including some of the ones mentioned above, we also believe in the importance of adhering to a data-driven investment process and not being at the mercy of emotions. Considering our view of a high probability of a market pullback, we would not be chasing these stocks higher at this point and would wait for better entry points to be buyers of many of these companies. Don't let FOMO trap you either.

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