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Integrated Alpha Investments

INVESTMENT INSIGHTS

The first half of the year was a marked change from recent market and economic behavior. Inflation, led by rising energy and food prices, emerged as the dominant economic force -- drowning out even Covid and the Ukraine as a news leader. Green shoots of cooling inflation have emerged, however, and modest improvements in the Ukraine should help further tame commodity prices. The Federal Reserve, perhaps a bit tardy, has adopted a hawkish tone and has backed up their rhetoric with swift and substantial action – more on than later.

From a Large Cap Focused strategy standpoint, we closed the quarter down 23.00%, off the benchmark by -6.33%. This result primarily comes from our risk management framework, which maintained a portfolio beta to the Russell 1000 Growth Total Return Index at approximately 1.0 for the second quarter, as well as the general underperformance of the semiconductor and technology spaces this year. We now see deep discounts in these names and intend to hold them as their valuations correct upwards. This is consistent with our investment process since we are thinking long term and expect these names to recover on the strength of their earnings and revenues acceleration.

FED ACTION

Equity markets continue to be volatile with the VIX at 31 at the writing of this commentary. As we know, intrinsic lags in economic indicators make monetary policy unavoidably slow and oftentimes late to arrive. The Federal Reserve's recent 75 bps increase, itself on the back of prior 25 bps and 50 bps increases, is expected to continue to cool off the economy. Despite market consensus estimating (hoping) the Fed can achieve its mandate of price stability without driving the economy into a recession, Chairman Powell and various other governors have made clear the Fed is prepared to continue hikes until inflation is tamed, even at the risk of recession. We ask the reasonable question: what if a recession were to happen? We think such a recession would be relatively brief in duration and odd in character given the relative strength of the economy. Similarly, we do not expect to see stagflation because, quite simply, the fundaments of the U.S. economy do not point in that direction. Consequently, we expect the Fed's actions to succeed in hitting the brakes on inflation while equity markets absorb a brief recession, much of which is already priced in.

OPPORTUNITIES

Historically capital markets tend either to overreact or underreact to significant economic news such as the recent Fed action. From both a fundamental and technical perspective, the recent bear market appears exaggerated and should, for some investors, open the doors to great growth stocks at value prices.

In addition, low valuations can lead to higher M&A activity. For instance, acquisitions or partnerships would make sense for some electric vehicle makers -- especially since the demand for semiconductors is expected to continue to increase and outpace supply. Should Tesla (TSLA) and Ford (F), for example, begin to make some of their most critical chips in-house? Another example comes from mega cap cloud service providers like Amazon (AMZN), Alphabet (GOOGL) and Microsoft (MSFT), any of which could differentiate itself further by buying a data and security analytics company like DataDog (DDOG). Oracle (ORCL) might benefit from a No-SQL database like Mongo Database (MDB). Many more examples could be given, but the point here is that strategic thinking could provide additional fuel to a future rally.

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INVESTMENT INSIGHTS (continued)

QUANT ACTIVE PROCESS

QUANT

All popular quant factors are underperforming YTD. That includes value factors like Forward P/E and growth factors like Sales Growth and Earnings Momentum. And since we are in this together, our FScore and MScore have been underperforming as well, as earnings momentum is related to earnings acceleration.

Pound for pound, we harvest more out of our quant factors compared to their typical. That is because we created them and we understand both their strengths and weaknesses. For instance, our FScore (our fundamental score which summarizes our view of earnings and revenue acceleration) is far more critical than the Score (purely technical). As expected, over a bearish period such as YTD, we need to discount the MScore but never the FScore because over time the growth rate of growth rates (acceleration) is an economically sound way to search for opportunities. This opens the doors to growth and some value companies as well.

DISCRETIONARY

Portfolio positioning across all Integrated Alpha strategies is where we want it to be, i.e., we are holding on to companies that have real growth potential. We like some companies in semiconductors – e.g., AMD (AMD), Nvidia (NVDA) – which fit the traditional high earnings growth expectations. Some airlines – e.g., Southwest Airlines (LUV) – will benefit from improving COVID news and a resurgence of business travel despite higher fuel prices, which could come down very quickly, reversing the crowded energy trade.

OUTLOOK

In the near term, equities can always encounter potholes (and craters such as the first half of the current year), but they can recover quickly, particularly when economic fundamentals are stronger than expected. Currently oversold conditions are likely to mean revert. When? We cannot rely on timing the market for success; instead, we rely on our process, which is guided both by stable quant factors and investment experience. Market timing is not a path to investment success. One might hear a handful of market timing success stories. These stories capture attention because we, as humans, love a simple story with a happy ending. Conversely, it is in our nature to ignore the far more numerous stories of market timing failures. As challenging as the first half of 2022 has been, investing is always about tomorrow. Our best advice remains to stay the course and continue to think long-term with your equity investments.

DISCLOSURES

This report was prepared by F/m Investments, a federally registered investment adviser under the Investment Advisers Act of 1940. Registration as an investment adviser does not imply a certain level of skill or training.

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