PARUS
FINANCE

July 29, 2024

Parus Fund Letter – H1 2024

Dear Investors,

The net performance for H1 was +10.5% for the USD class, against +10.8% for the MSCI World Index. The compounded net annual return since inception of the strategy in 2003 is +11.4%.

After a broad rally in 2023, equity performance was far more selective in H1 2024, with growth outperforming value. Quality businesses with robust growth driven by strong secular tailwinds outperformed. Conversely, more cyclical and GDP-sensitive businesses with weaker balance sheets underperformed.

Yet at the time of this letter, equity markets are experiencing a sharp rotation. Many AI beneficiaries are retracing some of their recent gains, while at the same time value and small caps are advancing. In the past two weeks alone, the smaller-cap Russell 2000 has outperformed the Nasdaq 100 by 14%.

The S&P 500 Growth vs. Value chart illustrates growth's outperformance since 2010, supported by continued positive earnings revisions. Yet, it also reveals the period of excess in 2021 and raises questions on the overall outlook today. We will discuss this in more detail through the letter and think the situation today is materially different from 2021.

S&P 500 Growth v S&P 500 Value

Source – Bloomberg

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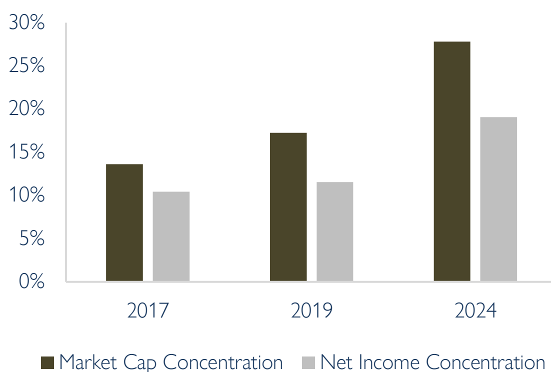
Market Concentration: Cause for Concern or Justified?

The first question that comes to mind is whether the current market concentration through mega caps is justified. The US and Global indices are increasingly led by large caps - the five largest companies in the S&P represent 28% of the index's market cap while their combined earnings account for 19%. This compares to 17% and 12% in 2019. In five years, their share of the index has grown tremendously, but so has their share of earnings. In the end the multiple of their share of market cap to earnings is not very different, at 1.5x now vs 1.4x in 2019. YoY sales growth at 24% today vs 15% in 2019, can also suggest that the premium is justified and one could make the case that the multiple premium adjusted for growth is actually lower now than it was in 2019.

Another way to look at it, the 12m forward P/E multiple for the group is at 29x now which is similar to the 30x of 2017, with both years showing similar top line growth of 24%.

Top 5 S&P Members



	Top 5			S&P		
	P/E	Sales Growth	EPS Growth	P/E	Sales Growth	EPS Growth
Today	29.5x	24%	51%	20.2x	3%	7%
2019	26.8x	15%	7%	18.4x	5%	2%
2017	30.1x	23%	26%	18.2x	6%	8%

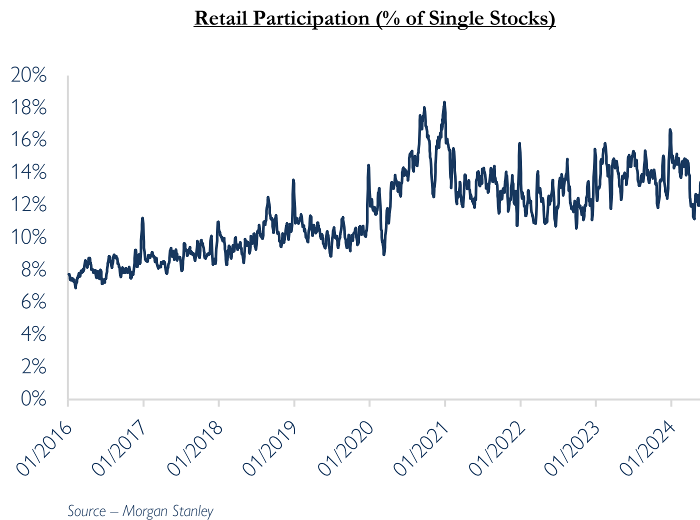
Source – Bloomberg

In Q2 2024, mega-cap outperformance led to a +4% gain in the market cap-weighted S&P index, while the equal cap-weighted version declined by -3%. This underscores the advantage of our focus on single-name shorts over index hedging. Indeed index hedging often used by strategies with more leverage can be pernicious. It is one thing not to be long large mega caps, it is another one to be short the best companies in the world, and Q2 was quite costly in that regard.

Final point on this matter, this level of concentration can be a source of higher market volatility and index retracement and the sharp divergence between the smaller cap Russell 2000 and the Nasdaq 100 in the past 6 months is case in point.

Another 2021-Style Bubble? We think Not

The question of the market excesses is a valid one. Especially when considering the high level of retail participation in the market, often a sign of excess optimism.



We were vocal about the excesses of technology valuations at the end of 2021, which provided a source of significant short opportunities in 2022. The environment in 2021 had many elements of a bubble. The prospect of a new digital world where people would work and live from home was a temporary phenomenon, and even though digital use was accelerated by Covid, working habits normalized thereafter. 2021 was a source of many excesses: unlimited money printing, SPACs, absurd valuations of non-profitable companies. The normalization of these excesses over time was inevitable.

Yet a new wave of innovation led by generative AI led the swift rally of 2023 and we believe we are entering a multi-year phase of accelerated innovation, of which we are only seeing the initial effects. The current wave of stock performance is supported by long-lasting fundamentals vs very temporary trends three years ago. For this reason, even though we are not surprised to see some short term stock market correction after a very strong outperformance of the winners, we believe that over the long term the fundamentals will fully justify current valuations.

In conclusion, we believe strong growth prospects justify recent valuations and the leadership of Tech companies, which does not mean that there won't be corrections from time to time. In the end, markets have their technical moves and the only thing we can do, as we have for 22 years, is focus on fundamentals.

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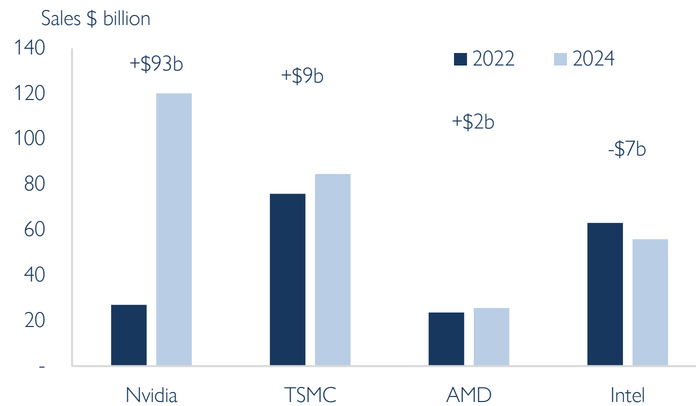
Nvdia and Semis

Semis have been the biggest sector of outperformance since the emergence of generative AI. Yet within this group, there is a massive dispersion between names. Currently only Nvidia has seen its revenues properly transformed by AI. TSMC, which produces most Nvidia chips, AMD and Intel have sales forecasts for 2024 close to the previous peak of 2022 (+$9bn for TSMC, +$2bn for AMD and -$7bn for Intel), while Nvidia is forecast to increase its sales by a staggering $93bn.

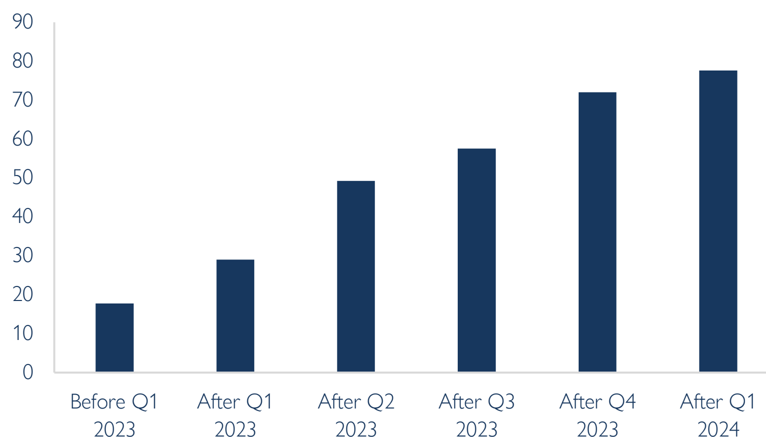
Nvidia v Competition



Source – Bloomberg, Company, Parus

Nvidia consensus keeps being revised upwards and the seemingly massive increase in EBITDA observed before and after Q1 2023 results (+$11bn) looks small in comparison to where we are now with expectations of +$61bn. This is the largest increase of consensus in such a short period of time ever observed, hence the reason for showing this graph in all our quarterly calls since Q1 last year. This fits within our investment process, recognising that very strong long-term drivers take a long time to be fully grasped by the market.

Nvidia Consensus CY 2024 EBITDA



Source – Bloomberg

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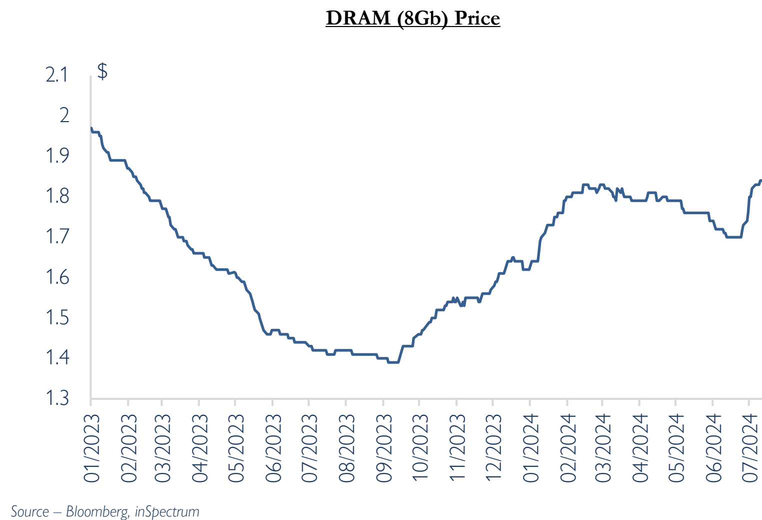
The surge in Dram prices presents another opportunity, following an extended period of weak demand, depressed earnings and subsequent reduced capacity investment from memory companies. This is a classic capital cycle creating a favourable supply demand imbalance which has been exacerbated by future AI demand. We have a position in Samsung, which is a major beneficiary of the increase of Dram and Nand prices, and oddly trades at a discount to its competitors Hynix and Micron despite being the most profitable and largest player.



Finally, we remain mindful of the massive increase in semiconductor capacity planned over the next few years across multiple geographies and sub-segments, led both by AI and the competition between China and the West to reach manufacturing autonomy. The latter, very much like a prisoner's dilemma, could lead to future overcapacity and a challenging earnings environment for industry participants. Even shorter-term, Semis are known for their mini-cycles making Nvidia, despite the phenomenal increase since 2017, a difficult stock to own at full size.

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Data Points

While we sometimes spend a significant portion of our letter highlighting macro data points at the inflection of economic cycles, and despite the fact that there are mixed data points on the consumer side, we believe secular drivers are more important to current stock selection. Hence we will only mention a few data points in this letter.

Firstly, the narrowing gap between labour demand and supply suggests a slightly softer labour market, potentially easing core inflationary pressures but also consumer demand.

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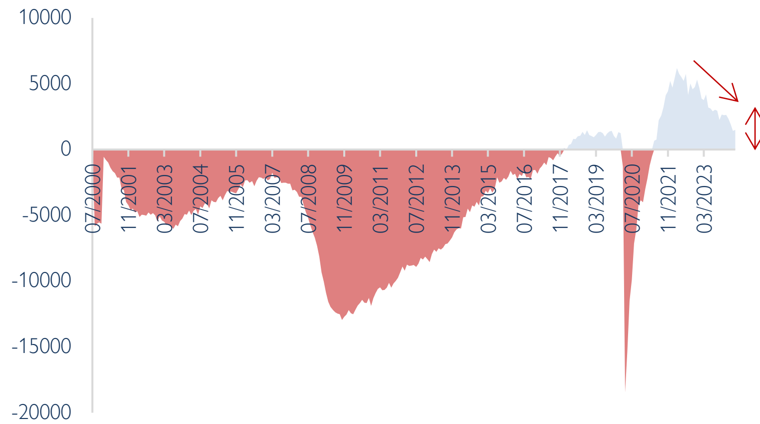
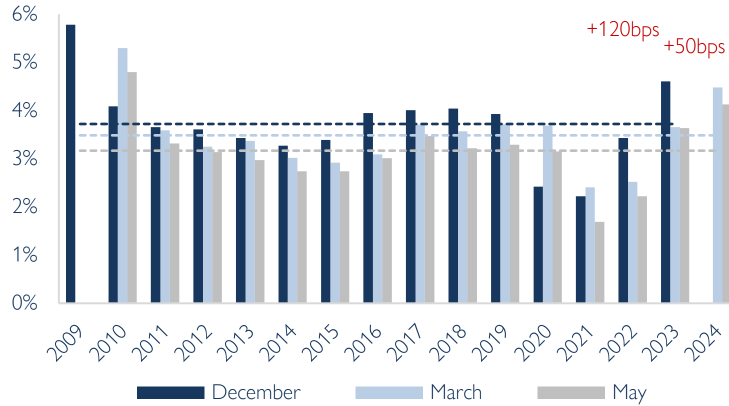
US Job Openings minus Total Unemployed Workers



Source – Bureau of Labor Statistics, Bloomberg, May 2024

Consumer delinquencies are rising at a slower pace. This translates into a consumer that is still strained given the elevated absolute levels of defaults, especially as the pockets of Covid-related savings dwindle, and yet the deterioration is not getting out of control.

Capital One 30+ Delinquency Rate

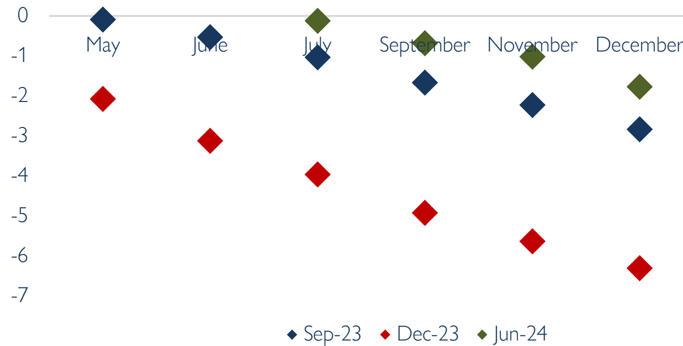


Source – Company, March, May and December each year

The impact of a softer labour market and rising delinquencies aligns with a slightly weaker consumer environment, evident in the poor quarterly results of some companies in luxury, apparel, and airlines.

Finally, it is worth highlighting that after hopes for very quick rate cuts around December last year – which was particularly painful for our short book, the market is now projecting similar cuts as it was in September last year.

Federal Reserve Implied Number of Rate Cuts



Source – Bloomberg

The elephant in the room to keep in the back of our mind remains the elevated deficit of western economies, exacerbated by demographic pressures and social transfers. While this remains a background consideration that the flexibility of our investment process should enable us to react to, it currently offers limited alpha generation potential.

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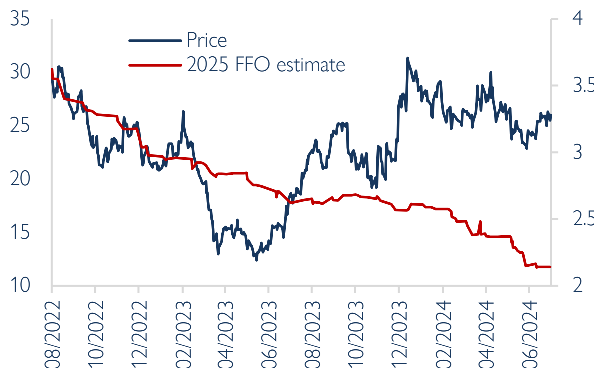
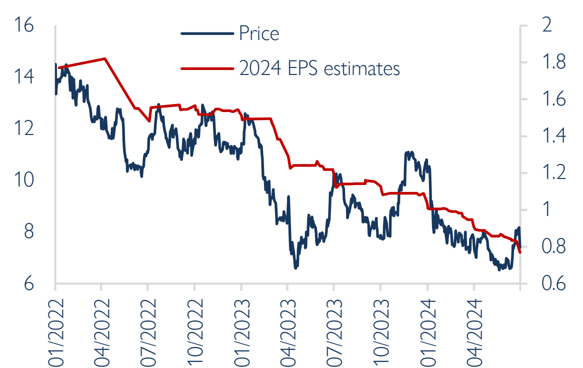
Shorts

As we have monitored over the past 18 months, the earnings and cash flows of some of our debt related shorts continue to decrease. Whilst many companies in the office REIT sector have been quite agile at extending financing and kicking the can down the road, the charts below are a good illustration of the economic reality of higher rates on stretched balance sheets in a sector plagued by excess supply. The FFO of Vornado, a New York exposed REITs, as well as the EPS of Valley National Bank, highly exposed to the New York and New Jersey commercial market, continued their unabated decline.

Vornado Price and FFO



Valley Price and EPS



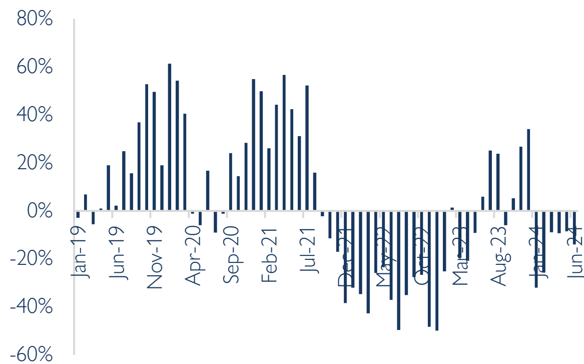
Source – Bloomberg

LGI Homes, another short position, has been suffering from a tepid housing market. This pressure is well reflected in negative YoY primary home sales and deteriorating operating metrics, notably slowing Monthly Closings and Closings per Active Selling Community.

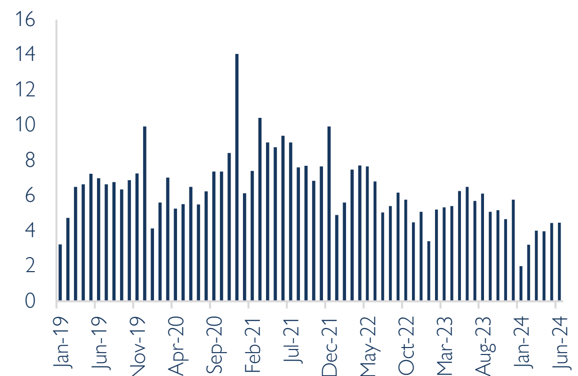
Home Sales YOY

Source – National Association Realtors, May 2024

LGI Homes YOY Monthly Closings



LGI Homes Closings per Active Selling Community



Source – Company

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PDD

We bought a position in late 2023 in PDD Holdings which we have added to in H1. PDD is the parent company of Pinduoduo and Temu, and has emerged as a formidable e-commerce disruptor in China and internationally.

PDD is spearheading a new wave of e-commerce innovation with group buying and social commerce, much like the transformative shifts from local shops to supermarkets and from physical stores to online shopping. This has allowed them to rapidly capture market share from established giants like Alibaba and JD in China, and even impact Amazon in western markets.

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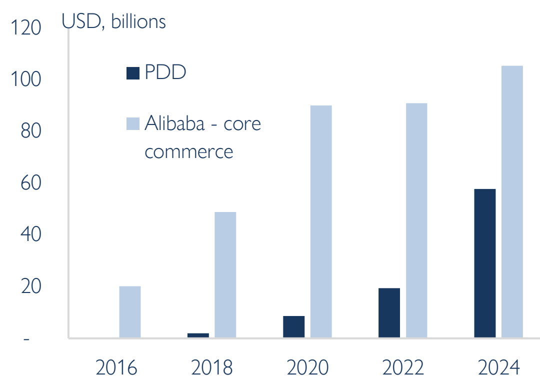
PDD's platforms are known for their highly competitive pricing financed by delayed delivery, which have contributed to strong user engagement and growth. The company is now replicating its successful domestic strategy internationally with Temu. PDD's "fully entrusted" model has proven attractive to merchants and consumers by offering low operational requirements, controlled pricing and quality of service, and lower prices respectively. Despite its strong growth trajectory and improving unit economics in maturing international markets, PDD's valuation multiples are remarkably low at 9x 2025 with revenues, whilst still growing at 130% YoY last quarter.

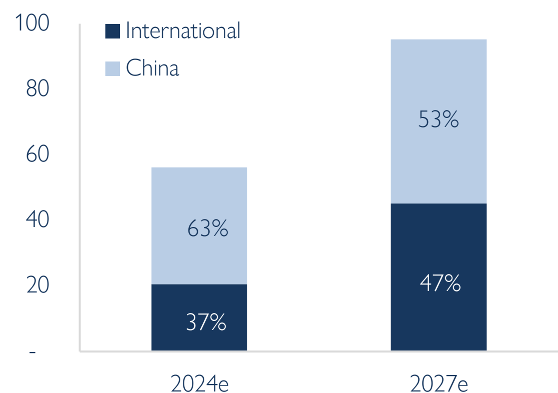
The first graph shows the impressive gain of market share against Alibaba while the second one illustrates the rapid growth internationally as the Chinese market matures.

PDD Revemue v Alibaba



Source – Company

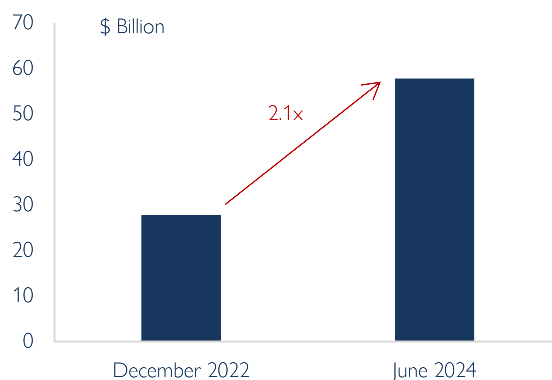
PDD Geographic Exposure



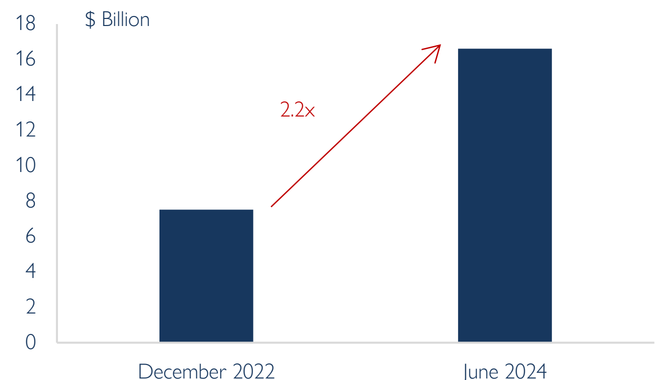
Source – Parus

The impressive execution in both markets explains why the consensus had to revise its forecasts of both sales and EBITDA by more than 100% between 2022 and 2024.

PDD 2024 Revenue Consensus



PDD 2024 EBITDA Consensus



Source – Bloomberg

Of course, part of the low valuations can be explained by the Chinese political discount as well as the strong protectionist pushback coming both from the US and Europe. Yet the

execution track record and the growth makes the low valuation particularly attractive for a company that should trade above 40x earnings otherwise.

* * *

In conclusion, our current portfolio reflects our commitment in investing in long term compelling growth stories in a world brimming with innovation. A mixed set of consumer data points justifies our focus on quality growth companies over more cyclical financially weaker businesses. While we envisage increased market volatility due to upcoming elections and increased investor participation, we remain confident in our investment process and its ability to navigate these challenges.

As always, we encourage investors to prioritize our overall investment process over short-term portfolio positioning.

With this mind, we wish you all a pleasant summer.

Sincerely

The Parus Team

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