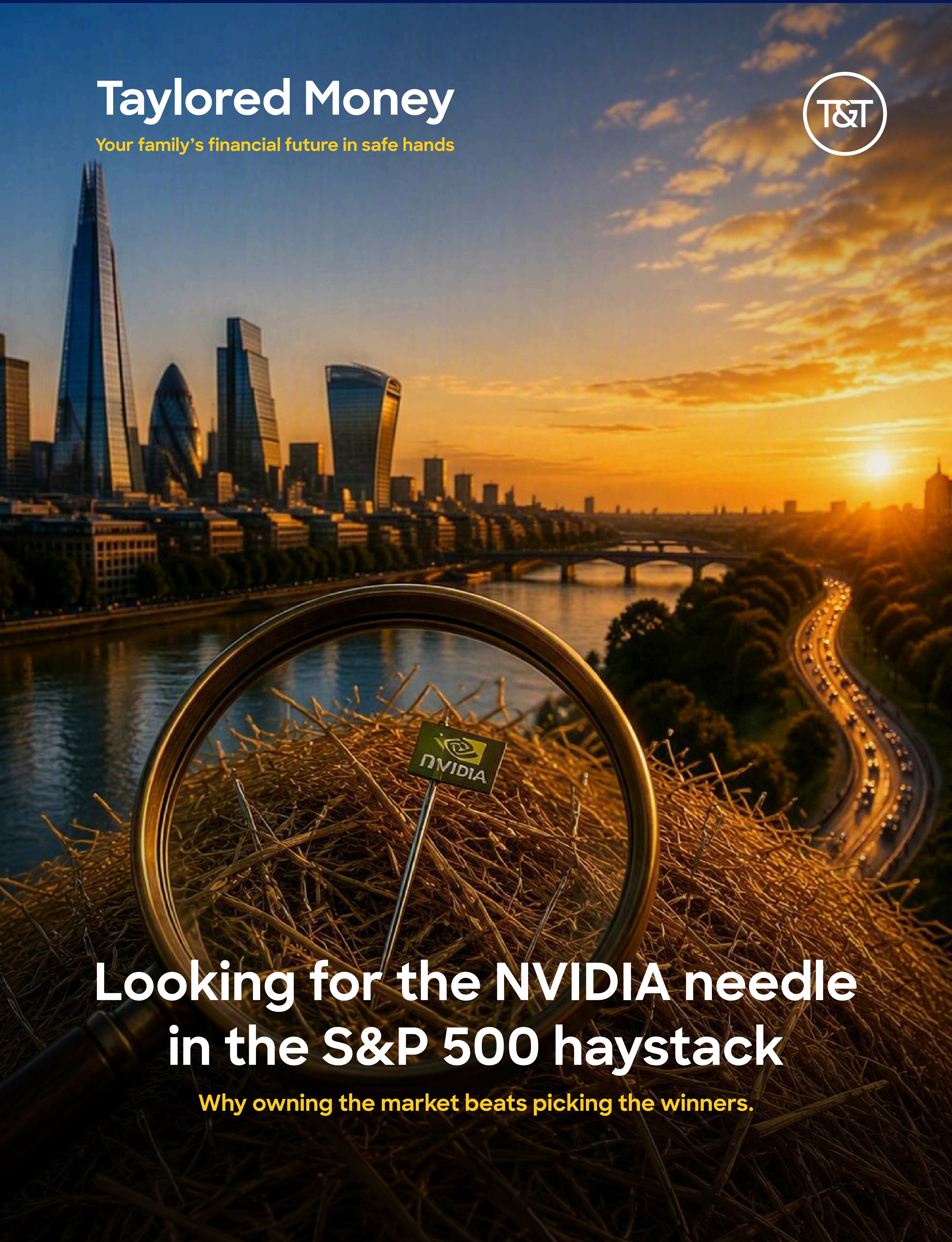
Taylored Money

Your family's financial future in safe hands

T&T



Looking for the NVIDIA needle in the S&P 500 haystack

Why owning the market beats picking the winners.

LOOKING FOR THE NVIDIA NEEDLE IN THE S&P 500 HAYSTACK

Investors seems to have gone mad for NVIDIA, the world's leading supplier of artificial intelligence (AI) hardware and software amongst other things. Its stunning earnings report in mid-February exceeded market expectations and its share price rose by over 20% in a day i.e. around US$277 billion was added to its market capitalisation. To put that in perspective, BP's total market capitalisation is today around US$100 billion.In fact, NVIDIA's share price has risen 61% so far in 2024, following a 240% rise in 2023 and over the past three years, it is up an incredible 480%. Don't you wish you owned it back then? In fact, you probably did but you just did not notice, as we explore below.

The story of NVIDIA provides some useful lessons. The first is that it is very difficult to foresee the future. Ten years ago, NVIDIA represented around 0.1% of the S&P 500 index in the US. No one was focused on AI or cryptocurrency, which NVIDIA has also benefitted from as they design graphics processing units (GPUs) used in the mining process for many cryptocurrencies, and few had forecast NVIDIA to be a future winner. When new information is released – such as the latest earnings report - it is rapidly incorporated into market prices. New information is, by definition, a random event and therefore well-nigh impossible to predict.

The second is that a good company such as NVIDIA is not necessarily a good investment.All the speculative thinking around AI and NVIDIA's role as the leading AI chip provider is already baked into today's price, which is around 65 times its earnings per share. That is a pretty heavy growth expectation to carry. The company's future earnings growth may exceed expectations and its shares might rise further, or they may not, and its shares might fall. Beware of anyone who thinks they know better than the market at this point. They are betting against randomness.

Third, by owning a very well diversified systematic fund (e.g. an index fund) investors did in fact own NVIDIA 10 years ago. Take a look at the chart below, which illustrates the size of each company in the US S&P 500 index. NVIDIA is the little yellow square, lurking in the bottom end of the index.

If we wind the clock forward to today, the picture is very different. The 0.1% holding of 10 years ago has become a holding of 4.6%, representing a 65-fold increase in its market weight. Note too how Apple and Microsoft have also grown. Ten years ago NVIDIA's share price was under US$5. Today it stands at US$776.

We know from empirical research that only around 4% of companies delivered all of the US market return above cash from 1926 to 2016[1]. You could play the game of trying to pick this 4%, but the empirical data suggest that very few professional managers are able to do so across time, and the chances of identifying these managers in advance of when you need them is very slim[2].
A better approach, in our opinion, is to make sure that companies that drive market returns are always in your portfolio. That is easy to do. Just own the market. NVIDIA may or may not be one of these '4%' companies, but recently it has certainly made a positive contribution to returns. The future's winners already sit in your portfolio or will do when they are listed on the stock market one day and captured in an index fund (or other highly diversified systematic fund). The great, late Jack Bogle who founded the Vanguard Group would agree.

> ***Don't look for the needle in the haystack. Just buy the haystack!***
>
> *John C Bogle (2007)[3]*

[1] Bessembinder, Hendrik (Hank), Do Stocks Outperform Treasury Bills? (May 28, 2018). Journal of Financial Economics (JFE), Forthcoming, Available at SSRN: http://dx.doi.org/10.2139/ssrn.2900447
[2] SPIVA ® US Year End Report 2022
[3] The Little Book of Common Sense Investing: The Only Way to Guarantee Your Fair Share of Stock Market Returns. John Wiley & Sons, Hoboken, New Jersey.

RISK WARNINGS

This article is distributed for educational purposes and should not be considered investment advice or an offer of any security for sale. This article contains the opinions of the author but not necessarily the Firm and does not represent a recommendation of any particular security, strategy, or investment product. Information contained herein has been obtained from sources believed to be reliable but is not guaranteed.

Past performance is not indicative of future results and no representation is made that the stated results will be replicated.