HÉRENS QUALITY ASSET MANAGEMENT

HALF YEAR REVIEW

July 2024

INSIDE THIS ISSUE:

Tech Titans, AI-exposure and Labour Market

Market Review and Performance Analysis 2

Corporate Excellence Insights Published in 2024 1H 4

Portfolio Investment Decisions in 1H 2024 5

In Focus: HQAM Quality Bond Certificate 8

Outlook: AI bubble or not, on the background of strong economy 9

HÉRENS QUALITY ASSET MANAGEMENT

CEO message

Dear clients, investors, and readers,

The end of the first half of the year routinely provides an opportunity to look back. Sometimes it is necessary to admit that things often turn out differently than predicted. This conclusion can probably also be drawn with regard to developments on the stock markets in the first half of 2024. It is true that many investors have become accustomed to the wars and political crises around the world and the market trend in the first half of 2024 was certainly not a one-way street. However, the fact that the stock markets performed so positively despite the lack of predicted interest rate cuts in the US can be seen as a surprise. This development continued to be driven primarily by future expectations in the field of artificial intelligence (AI). Many of the winners of 2023 continue to be among the companies sought after on the stock market. Even "long-established" companies such as Dell, whose business model had actually already been written off, are experiencing a comeback thanks to AI fantasies. The crucial question in this respect will be how much of the projected growth areas can actually be converted into sustainable profitability.

Profit growth is the key driver of the stock market. This shows that bubbles can certainly occur in certain areas in the short term. However, the decisive success factor is which company is able to build and further develop a stable and profitable business model in the long term. The fact that this is becoming increasingly difficult for companies with a weak business constitution, in an environment of technological upheaval and persistently higher interest rates, is also shown by the fact that there are more and more zombie companies, i.e., companies that are unable to cover their borrowing costs with their profits and are constantly having to take on new debt. One in five listed companies in the USA is now a “zombie”.

One factor that is often forgotten when investing in stock is time. Equities have by far the best performance characteristics, both in the medium and over the long term. The biggest market crises such as the financial crisis, the Asian crisis, the oil crisis or even the two world wars are only relatively "small kinks" - without wanting to trivialize the tragedy of these events - in a steadily rising performance curve. It is important that the fundamental quality of portfolio companies is regularly reviewed. If this is ensured, the best foundation is laid for creating sustainable value for generations. This has been our mission for over 20 years.

We wish you happy summer days and look forward to our future dialogue with you.

With best regards,
Diego Föllmi

1H 2024 Review

AI-exposed stocks rule the market

Since the beginning of the year, the market has been quite nervous with ups and downs whenever US statistical data was published, whether it was inflation, consumer confidence, or economic growth. All eyes were on central banks deciding whether to decrease the interest rates. Large swings, whether positive or negative, have also been seen during the reporting period. Often it is not about the results delivered below or above expectations. Now the forecasts for the next quarters and the year are scrutinized and affect share prices to a great extent.

The index performances were driven upwards by the leaders to a great extent, be it the US, Japan, or Europe. These leaders, as a rule, are heavily exposed to the AI craze, which has spilled over not only to IT but also to the Communications and Utilities sectors. In the US, IT (+27%) and Communications (+26%) stocks, especially the heavyweights, have contributed the majority of the year-to-date returns. Utilities (+11%) enjoyed AI euphoria too, as investors contemplated the implications of the rapidly expanding data center infrastructure on electricity demand growth. In Europe, the best performer was IT, followed by Health Care and Financials.

Conversely, the Real Estate sector in all considered markets was at the bottom of the performance leaderboard, as rate cuts were repeatedly deferred and have yet to materialize.

The investment style landscape does not look unexpected: Growth continues to massively outperform Value stocks, with a particularly large gap in the US, where the "Magnificent 7" continue to drive indices further. Momentum was the leader among investing styles with 29% growth. This phenomenon might be explained by the huge market power of passive investment vehicles, which to a great extent stimulate momentum growth. Quality style this time was lagging behind major indices because of its equal-weight approach and due to Quality's skew towards software businesses, while technology hardware led the performance in the first half. In Europe, the lack of exposure to financials also weighed on quality style performance. The first half of the year was obviously driven by large-cap markets, primarily in the US. In Europe, the situation was more moderate; although small caps lagged behind the general market, the gap was not that dramatic.

Further market movements will be influenced by the macrodata, given their role in rate changes, as well as whether companies will be able to fulfill market expectations regarding AI development.

	Quality*	Value	Growth	Small Cap	Market	Top 8*
USA	8.6%	7.1%	22.1%	1.8%	14.6%	
EU	5.5%	7.1%	11.0%	5.0%	9.1%	
CH	9.8%	10.7%	14.8%	8.6%	12.8%	
World	7.4%	9.5%	20.8%	4.2%	15.2%	9.1%

Fig.1 Performance (TR) 30.06.2024 by regions based on MSCI regional indices (Currencies: USA – in USD, EU - in EUR, CH – in CHF, World – in EUR); * - Hérens Quality Portfolios

Corporate Excellence Insights Published in 1H 2024

FEBRUARY 2024

Why “attractively valued” is not the same as “cheap”

Supported by improved earnings outlook, as well as reduced macro uncertainty amid evidence that inflation has not become entrenched, valuation of the equity market has expanded recently. Valuation of Quality has followed suit after suffering disproportionately in 2022. However, experience of the last two years is a vivid highlight that changes in valuation multiples can cause volatility of returns in the short horizon, but consistently predicting such swings is a futile endeavor. Over the long-run, however, fundamentals trump the short-term noise, leading to outperformance of Quality, despite its above-average valuation.

Read insight.

MARCH 2024

Rise of the (Neural) Robots – Part II

On February 14th 2023 we published our first CE insight devoted to AI and potential winners from the ongoing revolution - an equally weighted basket of stock picks mentioned in this article delivered a whopping 124% return (USD) as of end of March 2024, we also correctly mentioned the 2 biggest winners – Nvidia and Meta. We heard a lot of new buzzwords during earnings calls and equity market returns were largely attributed to Magnificent 7 gains that are natural winners as they provide infrastructure, have access to many clients, have data to build the models and capital to deploy these models at scale. Easy gains are over.

Read insight.

APRIL 2024

What makes a winning stock

Looking at the consistency of outperformance of long-term winners, only a few companies have demonstrated consistent market-beating performances year after year throughout the entire 10-year period. This stresses the importance of taking a long-term view – even the best companies can face temporary headwinds. At times, there may not even be any issues the business is dealing with, but the market just rotates into a different style or sector, as was the case in 2022. Still, outperformance of winners is usually not the result of a couple of blast years: long-term compounders deliver above-market returns more often than not, while underperformers tend to consistently disappoint.

Read insight.

MAY 2024

Industry bets – is it worth it

Making industry bets is very widespread in investing, be it active or passive approach. Some gamble with oil prices, some make bets on banks and interest rates, others have global mega-trends at the core of their approach. The key question is whether the industries can be systematically classified as higher quality lower quality. Long-term performance figures highlight the difference between financially stronger and weaker industries. The IT sector is clearly the leader, significantly outpacing other industries, primarily driven by the semiconductor group. In contrast, the energy industry is a value diluter, characterized by weak performance and substantial earnings volatility.

Read insight.

Portfolio Buy, Sell and Hold Decisions in 1H 2024

See below a few of our investment decisions regarding Quality portfolios in the first half of 2024. This half-year, we discussed many companies within the Investment Committee, but the portfolio composition remained stable in almost all markets. Therefore, we have just two cases to share.

Hold Decision

Apple

Since its inclusion in the US Portfolio in 2012, Apple has delivered over 1100% total return. However, we could not ignore the incrementally negative sentiment towards the company, as well as the significant underperformance since mid-2023. Following the demand boom during the pandemic, Apple's top line has been stagnating, while heavy exposure to China has become a headwind due to intensifying local competition and slowing economic growth. Additionally, concerns emerged that Apple is falling behind on innovation, as Samsung was quicker to introduce AI-enabled smartphones. On top of all that, news that Warren Buffett sold part of its stake in the Company during Q1 2024 added to the negative sentiment.

Apple was trying its fortunes in the VR space, but the lack of broad consumer interest suggested it was unlikely to become the next leg of growth. The market consensus seemed to be that Apple is a mature company in a saturated market, lacking growth drivers and 'overvalued' on top of that. Indeed, a P/E over 30 is no small price tag for a company with mid-single-digit sales growth.

We reviewed the bear thesis for Apple and concluded that these concerns are overblown.

Competitive risks are the nature of Apple's industry, and quarterly market share fluctuations are a feature, but Apple's dominant position is certainly not going anywhere, thanks to its sticky user base and the status symbol of the brand. While the company holds a modest high-teens share of smartphone shipments, Apple consistently captures over 80% of smartphone profit share, with its ASP almost three times the global average. Low-end Chinese rivals are gaining traction but target a different user base that is not a profit driver for Apple.

As to slowing sales growth, it is no surprise that hardware sales tend to be cyclical. The post-pandemic downcycle has lasted for a while, but we would point out that Services revenue (22% of total) has continued robust expansion, highlighting the strength of Apple's business model. Propelled by services revenue, Apple's gross margin has improved to 44% from 38% pre-pandemic. Meanwhile, the number of Apple active devices has increased by about 700 million, now surpassing 2.2 billion—a huge installed base for regular upgrades and for continued service revenue growth. This explains why the company continues to command a premium valuation despite slowing top line growth.

Speaking of innovation, we believe Apple's wait-and-see approach is smart, as the stickiness of the company's installed base allows it to gauge market reception of industry innovations and develop best-in-class solutions when the time is right. On AI, Apple did not leave the market waiting for too long: in June, Apple unveiled Apple Intelligence, software providing generative AI features to Apple devices, which is now expected to drive the next upgrade cycle.

In times like these, it is always crucial to get back to basics and ask whether business fundamentals have deteriorated or if the negative headlines are exaggerating the extent of the setbacks faced by a company. Since we reviewed the company, Apple is up by about 16%, helped by better-than-feared Q2 results and recently announced AI innovations.

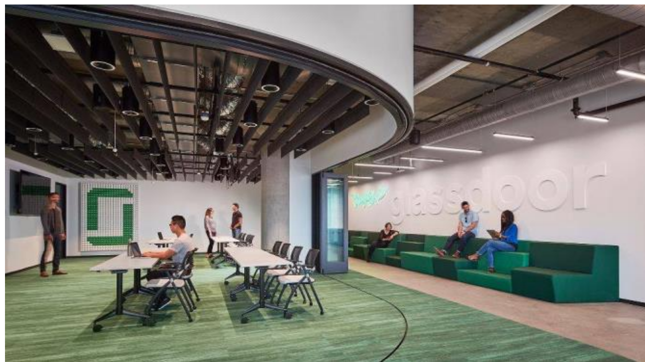
We believe Apple is still one of the highest quality companies in the world, but even the best companies sometimes go through a rough patch.

Buy decision

Recruit Holdings

In April 2024, we invested in Recruit Holdings, Japan's largest staffing firm and a key player in marketing media. Founded in 1960, Recruit has transformed from a small advertising agency into a global leader in human resources and information services. A significant milestone for Recruit was the 2012 acquisition of Indeed, a leading job search engine. This strategic move not only expanded Recruit's global footprint but also solidified its position as a dominant player in the online recruitment market. Indeed's innovative job search technology complemented Recruit's existing services, creating a comprehensive ecosystem for job seekers and employers. Later in 2018, Recruit Holdings' acquisition of Glassdoor further enhanced its HR technology portfolio, providing valuable insights into company reviews and salary information.

Currently, Recruit is estimated to hold approximately a 30% share of the domestic recruitment advertisement market. Additionally, its employment website, Indeed, leads job site traffic in more than 20 countries, ranking #1 in 13 countries and #2 in 9 others. Over the past decade, Indeed has doubled its unique monthly visitors and now delivers over three times more hires than any other job site. Furthermore, Recruit Holdings is well-known and respected in its operating industries, providing a competitive edge in attracting clients, partners, and talent.



Company consistently outperforms its peers despite industry challenges such as an aging workforce and economic fluctuations.

Recruit first caught our eye back in November, 2021, however, it was decided to wait a while before investing in the stock, due to the fact that companies financials were boosted by tight labor market.

When we revisited the case in April this year, we decided that it was time to take action as companies' profit margins had returned to pre-pandemic levels and the spike in the number of unemployed job seekers had eased. Additionally, Recruit consistently outperformed its peers despite industry challenges such as an aging workforce and economic fluctuations. The company demonstrated steady growth in sales, reflecting its robust operational strategies and market adaptability. In short, it has proved its quality status.

Recruit’s success is also evident in the fact that, since its inclusion in our portfolio, the company has returned 31.5% and outperformed the MSCI Asia Pacific Index by 28.8%. This achievement is attributed to better-than-expected full-year profit figures and excellent outlook primarily due to effective cost controls, while still continuing to invest in future growth across all business segments.

In Focus

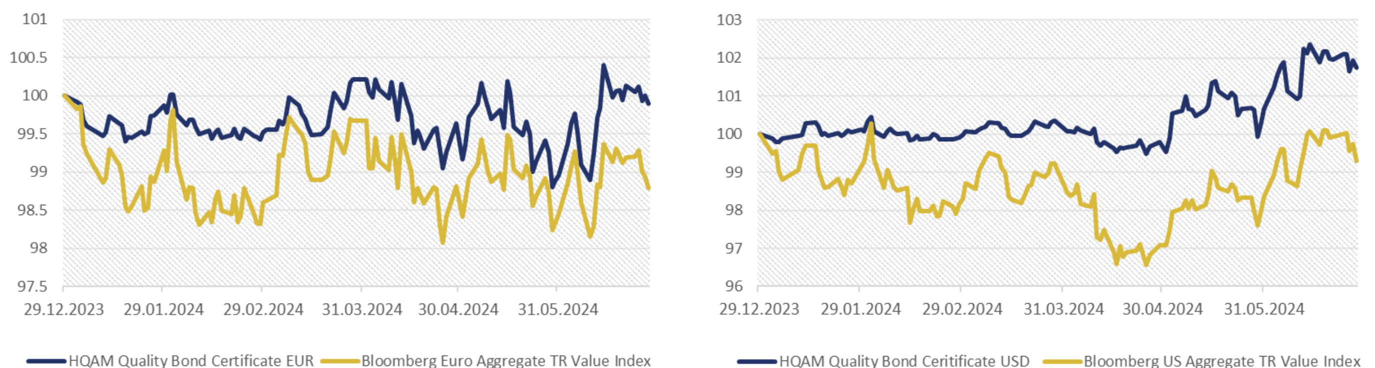
Corporate Quality Bond Certificates

With inflation showing signs of cooling, interest rates in developed economies are anticipated to decline. In the US, the journey from current rates of 5.5% to the forecasted 2-3% is longer compared to Europe's current rate of 4.25%. However, the potential for rate reductions is tangible across all regions. This market environment creates a favorable backdrop for bond investing, making this asset class attractive after a prolonged period of unfavorable conditions.

Our Bond Certificates, available in both USD and EUR, offer investment opportunities in corporate bonds that meet our rigorous quality standards and provide an attractive yield-to-risk ratio. Our investment strategy is primarily bottom-up, typically following a buy-and-hold approach, while allowing for opportunistic position exchanges when advantageous. The portfolio's goal duration varies depending on market conditions. At the beginning of 2023, our portfolio duration was significantly lower than the benchmarks to capitalize on higher short-term rates. However, by the end of the year, we shifted to longer-maturity bonds to lock in the high rates and better position ourselves for anticipated rate cuts.

As of the end of Q2 2024, our certificates maintain the same or higher yield to maturity with a slightly lower modified duration, reflecting our strategic adjustments to optimize returns in the evolving interest rate environment

Fig.1 Bond Certificate portfolio YTD performance in EUR and USD (Source: HQAM, Bloomberg)



Bond selection follows a strict procedure, the first step of which is the bond's rating determination via quantitative evaluation, considering both traditional and in-house developed financial ratios with a focus on cash flow generation ability. The second step involves qualitative evaluation, such as business model robustness, risk assessment, industry strength, and corporate governance quality. Additionally, an ESG analytical layer is applied to exclude controversial investment cases.

Bond holdings are closely monitored on a monthly basis to detect increased risk of corporate quality deterioration to protect portfolio value and generate a decent return on bond investments.

Fig. 2 Bond Certificate portfolio characteristics

	YtM	Mod. Duration
EUR Bond Certificate	3.75%	6.02
Benchmark	3.27%	7.79

	YtM	Mod. Duration
USD Bond Certificate	4.88%	6.13
Benchmark	4.88%	8.47

Source: HQAM, Bloomberg

Outlook: AI bubble or not, on the background of strong economy

Economy is still strong but...

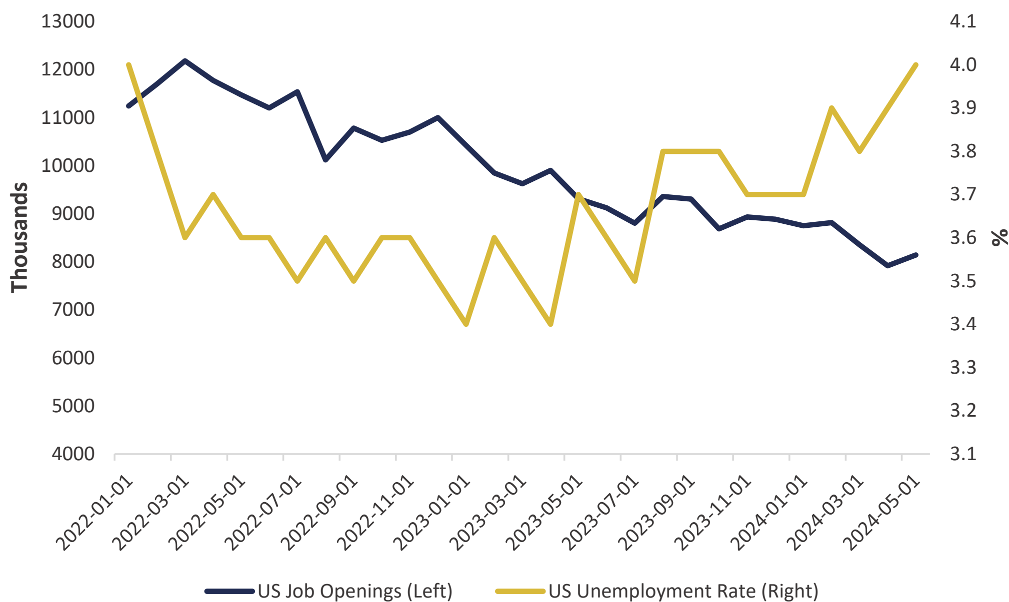
Market participants began betting on the number of interest rate cuts last autumn. The majority were wrong, not expecting inflation in the US to stay high for a prolonged time, partially caused by elevated oil prices and a tight labor market. The rates will go down eventually, but much more gradually than initially expected, unless the schedule is disrupted by unfavorable economic developments.

This time, we would like to focus on the healthiness of the labor market, which has been heated during the last 2-3 years due to labor shortages, leading to labor cost pressure worldwide and a low unemployment rate. New job offers are declining, new hires have started to decline, and new jobless claims are growing.

Surely, the labor market is becoming healthier, and perhaps companies can become more efficient thanks to automation, AI, or other reasons, but this may also be the start of a prolonged worrisome trend.

While the broad economy, particularly in the US, does not show any signs of swift weakening, the labor market might become a problem. If labor issues continue to mount and get out of control, they could become a trouble for the broader economy. Therefore, labor market developments should be closely watched to ensure that the trend towards becoming healthier does not go too far.

Fig. 1. US Job market indicators



Source: Refinitiv

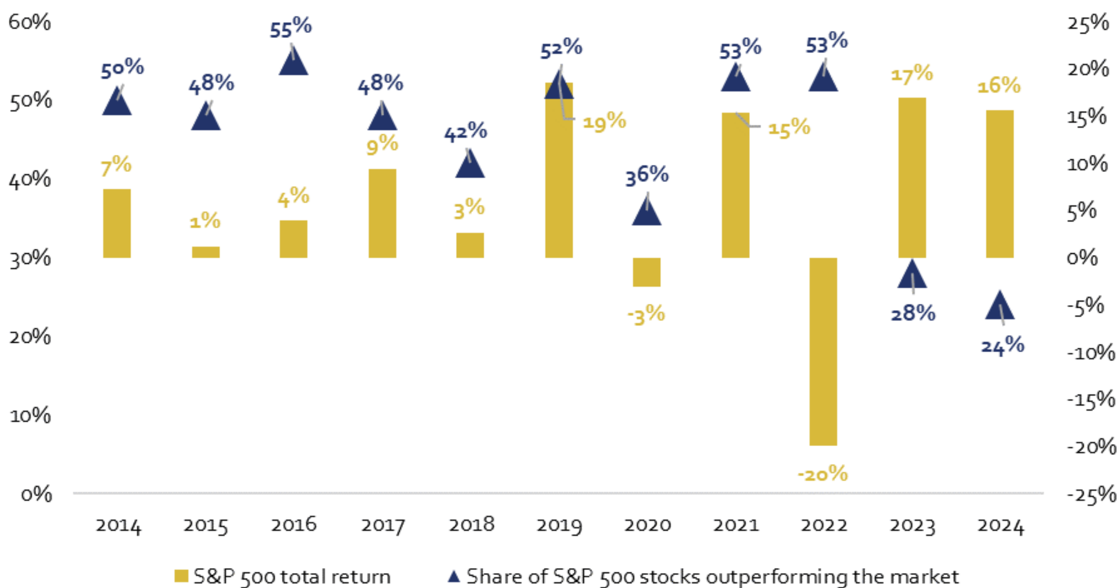
AI bubble?

25% of the S&P 500 companies outperformed the index and 37% actually finished the first half lower. This picture is quite uncommon to see alongside a double-digit return for the market, as was the case in H1 2024. 55% of index return was provided by top 5 contributors – Nvidia, Microsoft, Meta, Amazon and Eli Lilly. Nvidia is especially noteworthy, as it alone accounted for 31% of the index return, a truly remarkable feat, although performance of other semiconductor stocks was also generally very strong.

Has the market been overtaken by AI euphoria? Overall, we do not think we have already reached the bubble territory, although we remain cautious on certain names. While we do not doubt the potential of AI and Nvidia's role in the industry, we also feel that the market is asking too little critical questions. For Nvidia to maintain its status as the world's most valuable company, one would have to believe that hyperscalers will continue to pour more and more billions into Nvidia's technology, allowing the Company to enjoy >50% net margin year after year in the foreseeable future. Perhaps this is indeed how things will play out, but we do not have such confidence. Share price momentum can be a powerful thing, which feeds on itself via a FOMO, gamma squeeze and forced ETF buying loop. It risks creating a dangerous situation, when business fundamentals get detached from share price action.

Additionally, there is a lackluster situation with regard to other industries, where companies had to deal with weaker demand because of the high inflation (consumer exposed industries), as well as high interest rates (Industrials, home-builders). In such an environment, the appeal of companies with growth drivers that are disconnected from the economy is obvious. For example, the Semiconductors industry has enjoyed the highest forward earnings revisions over H1 2024 and is also expected to have one of highest growth rates in the coming two years, so its rise has been well-supported by fundamentals.

Fig.2. Total return of the S&P 500 and share of S&P 500 stocks outperforming the market during first half of the year

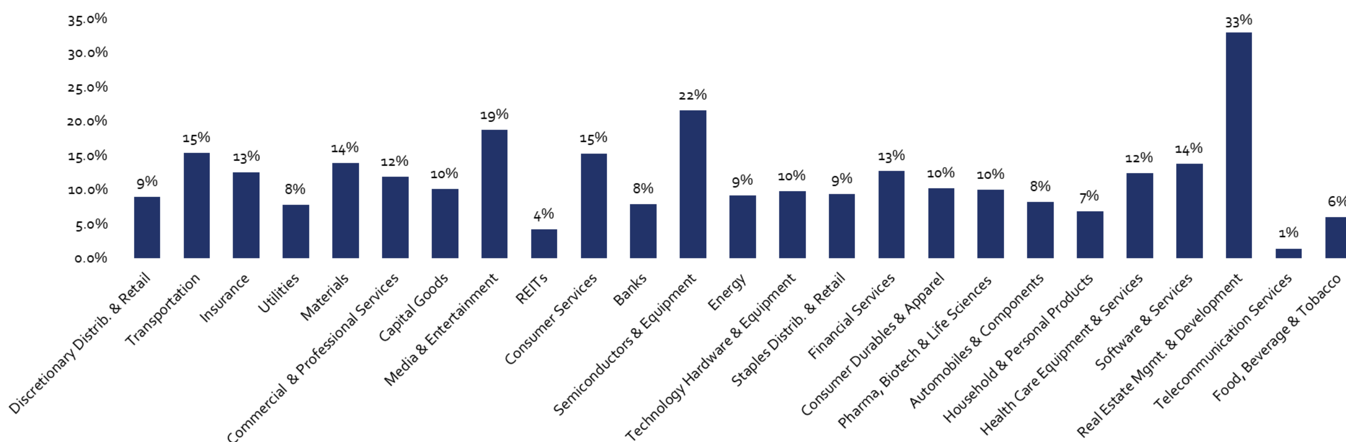


Source: Refinitiv

At the same time, as the market's attention is devoured by the shiny new AI toy, we think it also provides a ground for search of investment opportunities. For example, some quality names in the Software & Services industry have undergone a correction recently, as the market feared AI investments would detract from traditional software spend, while many names in the Pharma and Health Care Equipment industries have fallen out of favour amid risk-on mood.

Altogether, we do not yet view the narrowness of the current stock market rally as a warning sign. Rather than expecting a severe correction, we tend to think the rest of the market should catch up to the leaders. Ongoing slide in treasury yields ahead of the upcoming rate cuts, as well as early signs of stabilization of the manufacturing cycle could support a broader participation in the market's climb.

Fig.3. Median average EPS growth in the coming two years by S&P 500 industry group



Source: Refinitiv

About Us

Hérens Quality Asset Management AG is a highly entrepreneurial and solution-oriented investment management boutique focused on Quality investments since 2003. Our investment style is traditional, timeless and has its own performance and risk character. We believe that a clear, disciplined and systematic analysis offers the key to sustainable investment success. In both bond and equity asset classes, our analysis is based exclusively on proprietary research and analytical tools.

Performance overview

Quality Composites*	YTD	2023	2022	2021	3Y p.a.	5Y p.a.	Annual Return	Since Inception	Alpha**	Inception Date
USA (USD)	8.6%	36.8%	-31.5%	23.2%	3.9%	12.4%	11.3%	795.2%	0.9%	01.01.2004
S&P 500 Gross TR (USD)	15.3%	26.8%	-18.1%	29.6%	10.4%	15.3%	10.3%	641.6%	-	
Out-/Underperformance	-6.7%	10.0%	-13.4%	-6.4%	-6.5%	-2.9%	1.0%	153.6%	-	
Europe (EUR)	5.5%	21.3%	-21.9%	30.1%	3.1%	9.1%	8.9%	472.7%	2.3%	01.01.2004
Stoxx 600 Net TR (EUR)	9.4%	15.9%	-10.6%	24.9%	7.1%	8.6%	6.9%	295.4%	-	
Out-/Underperformance	-3.9%	5.4%	-11.3%	5.2%	-4.0%	0.5%	2.0%	177.3%	-	
Switzerland (CHF)	9.8%	8.3%	-23.3%	30.2%	-0.1%	8.1%	8.9%	475.0%	1.8%	01.01.2004
SPI (CHF)	9.2%	6.1%	-16.5%	23.4%	1.2%	5.8%	7.0%	301.6%	-	
Out-/Underperformance	0.6%	2.2%	-6.8%	6.8%	-1.3%	2.3%	1.9%	173.4%	-	
TOP 8 (CHF)	12.8%	36.0%	-34.8%	41.9%	3.1%	12.2%	15.5%	307.7%	6.2%	01.10.2014
MSCI World Net TR (CHF)	19.7%	12.7%	-17.0%	25.7%	6.0%	10.1%	9.0%	132.1%	-	
Out-/Underperformance	-6.9%	23.3%	-17.8%	16.2%	-2.9%	2.1%	6.5%	175.6%	-	
Global Quality TOP 15 Equity Fund I Class (EUR)	9.3%	31.3%	-26.0%	37.5%	6.5%	-	12.3%	73.6%	-0.6%	01.10.2019
MSCI World Net TR (EUR)	15.2%	19.6%	-12.8%	31.1%	10.5%	-	12.7%	76.5%	-	
Out-/Underperformance	-5.9%	11.7%	-13.2%	6.4%	-4.0%	-	-0.4%	-3.0%	-	
Aramus Japan Equity Fund I Class (JPY)	4.7%	22.7%	-17.2%	2.9%	4.3%	8.1%	7.4%	122.5%	-2.2%	01.04.2013
TOPIX (JPY)	18.7%	25.1%	-5.1%	10.4%	13.1%	11.3%	9.5%	178.1%	-	
Out-/Underperformance	-14.0%	-2.4%	-12.1%	-7.5%	-8.8%	-3.2%	-2.1%	-55.6%	-	

* Composite: incl. transaction costs, div. reinvested, without management fees
** Annualized Alpha (risk adjusted)

As of: 30.06.2024
Source: Hérens Quality AM

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