



2<sup>nd</sup> Quarter 2024 Client Letter

## How to Pronounce Nvidia

July 2024

Is the company pronounced “N-Vid-E-Ah” or “Nuh-Vid-E-Ah”? We’ll get back to the correct answer in a bit, but maybe a name like “Rocket”, “Jackpot”, or “Dynamite” would be more appropriate. They certainly better describe the company’s recent performance -- in addition to having more universally agreed upon pronunciations.

First, a review of where we currently stand: The S&P 500 finished the 2<sup>nd</sup> quarter up 14.5% against a backdrop of a Federal Reserve still committed to high interest rates and declining, but still challenging, inflation. The S&P’s gain, while excellent, is not representative of the broader stock market, because the average stock was only up 4.1%.<sup>1</sup> Nvidia, Apple, Amazon, Meta, Microsoft, Alphabet and Tesla, collectively known as “The Magnificent Seven”, were responsible for 60% of the market’s move, continuing an ongoing trend. Nvidia in particular represented 30% of that move due to its own 37% gain during Q2, capping a stunning first-half increase of 149%. In early June, Nvidia briefly hit a \$3 trillion market value, making it the most valuable company in the world for a short time.<sup>2</sup> Having this company in your portfolio (along with the other six members of the Magnificent Seven) may have been the only path to out-performance during the quarter. Most other asset classes’ lackluster showing – particularly bonds and the Dow Jones index – in Q2 lends weight to this notion. (Dow Jones Industrial Average -1.27% QTD/+4.79% YTD; S&P 500 +4.28% QTD/15.29% YTD; NASDAQ +8.47% QTD/+18.57% YTD; Bloomberg US Bond Aggregate +0.07% QTD/-0.71% YTD).<sup>3</sup>

Nvidia’s explosive growth this year has been powered by the release of its new line of Blackwell computing processors. Blackwell chips are up to 30 times faster than Nvidia’s current flagship H100 chips, while consuming 25 times less energy and providing more custom solutions than the older brethren.<sup>4</sup> These significantly improved new entrants are expected to drive consistent revenue gains going forward for the foreseeable future, which has led investors to pile into the stock. However, Nvidia’s 2024 outperformance is nothing new – from 2020 to the present, the company has increased its sales from \$10.9 billion to \$60.92 billion, reflected in an annual earnings growth of approximately 63.7%.<sup>5</sup> Accordingly, over this 5-year period, Nvidia’s stock is up over a total of 1,900%, with a current price hovering around \$130/share after the stock recently split 10 for 1.<sup>6</sup>

But is the stock now too expensive? One way we can assess this is with a metric called the PEG ratio, used by many analysts and portfolio managers to measure the value of a fast-growing company. As a simple explanation, the PEG ratio is a stock’s price-to-earnings ratio divided by the growth rate, and a PEG ratio of 1 is fairly valued. PEG ratios above 1 are generally considered overvalued, and below 1 is considered undervalued.<sup>7</sup> Nvidia currently has PEG ratio of 1.42, which normally would be considered above fair value. Yet when it is compared against the PEG ratio of

the other Magnificent Seven stocks, a different picture emerges. As an average, the Magnificent Seven's current PEG ratio is 2.6 – by comparison, then, Nvidia is actually relatively cheap.<sup>8</sup> Of course, this is just our interpretation, and we could find you a host of other investment pros who would disagree. However, most of Wall Street seems to be thinking along the same lines: Currently, 59 major investment and analyst firms rate the stock as follows: Strong Buy 18, Buy 36, Hold 5. There are no current sells within this group.<sup>9</sup>

However, performance often doesn't seem to dictate a stock's success in the short run versus the messaging Wall Street is listening to. Often, it seems the most effective messages are simply the loudest and most persuasive opinions – accuracy isn't a requirement. A persuasive analyst or fund manager with a negative argument can produce doubts in even the most seasoned investor. The same can be said for the public remarks of hedge fund managers, mutual fund research directors and wealthy private investors. Stocks always fight these walls of negative opinion, which creates the resistance that produces the sellers. Entire careers can be made on a correct call at the top or bottom of a market, and high-flying stocks that attract a lot of media attention like Nvidia are particularly juicy targets for such calls.

Eventually, however, analysts must be right to remain in the game. JP Morgan's Chief Market Strategist Marko Kolanovic, who just announced his resignation, is the most recent example of this phenomenon. Kolanovic remained bullish during the stock market's brutal 2022 decline only to turn bearish at the bottom in October of that year. He remained so until his recent departure.<sup>10</sup> It is likely that his forecasts cost JP Morgan's investors a lot of money in the last few years. This is not to single out Kolanovic, but rather to demonstrate the power one individual at a powerful firm can have when they go the wrong way on a call. It needs to be understood that there are many axes to be ground in the forest of investment options.

We think personal wealth has always been accumulated by buying and holding superior growth companies over many years. Historically, companies such as Berkshire Hathaway, Coca-Cola, Procter & Gamble, Philip Morris, Exxon, Johnson & Johnson, Walt Disney and Walmart have made long-term holders a great deal of money. Yet the path to riches is littered with once great companies that went bankrupt because they couldn't maintain the dream. Sears, Eastman Kodak, General Motors and Polaroid are such ghosts. If we judge stock market performance by market capitalization, the most successful stocks of the last 30 years are (in order): Apple, Microsoft, Nvidia, Alphabet and Amazon.<sup>11</sup> These companies share two traits in common: Great management and an exclusivity of product or service—a moat. All those companies had great owner-founders who were able to lead their companies to dominance by creating or leading a market and then keeping their companies in that dominant position. Beyond that, once the founders stepped down, new leaders were found who could carry on their tradition of greatness, with Tim Cook of Apple, Microsoft's Satya Nadella and Amazon CEO Andy Jassy being three such individuals. To do so over multiple decades is much more difficult: Procter & Gamble, Eli Lilly and Walmart are some of the few examples. "Be the best and remain the best," could be their corporate creeds.

It is interesting to note all the five aforementioned best over the last 30 years are technology stocks. Not content to rest on their laurels, all of them are devoting significant resources to artificial intelligence (AI) to maintain their preeminent positions. Technology is defined as, “the application of scientific knowledge for practical purposes, especially in industry.”<sup>12</sup> Viewed from that perspective, all the stock market leaders throughout modern history were technology companies in their day—they all created new industries (railroads, steel, telephones, automobiles, chemicals, computers, etc.). It could be argued that oil companies were the exception, but it was new methods of exploration, extraction, refining, distribution and the development of petrochemicals that allowed the U.S. to become a world-leading industrial power. It’s pretty clear to us that the laboratory leads the factory, and not the reverse. To that end, we believe properly harnessed AI should accentuate and accelerate this process. Time will tell.

To return to our opening question, Jensen Huang (Nvidia’s chairman) pronounces his firm’s name “N-Vid-E-Ah,” so we should go with that. But the real question is whether Nvidia can maintain its premium price and continue to increase it. Given that markets adapt to information so quickly these days, it seems like a stock’s price is held hostage to its quarterly performance. Nvidia’s meteoric in the last year has been the result of a string of blockbuster quarters that crushed earnings estimates. Going forward, each quarter’s earnings call should either confirm the company’s continuing success or signal a problem. The stock has a history of volatility, having experienced several 10% and 20% corrections in the last two years, only to rapidly recover, and we would expect this to continue. Sometimes, the declines can be even steeper, such as when the Federal Reserve began raising interest rates in 2021 and Nvidia’s price declined by 60%.<sup>13</sup> Selling entire positions and hoping to rebuy them at cheaper prices is fool’s errand with companies like this. Additionally, the tax consequences of frequent buying and selling (outside of retirement accounts) to try catching tops and bottoms defeats the purpose of a true growth strategy. One of the advantages of owning stocks with large gains is they provide a cushion to big swings in price. While it is risky to allow one position to overwhelm a portfolio, big positions are how wealth is built. Therefore, managing the weight of a stock in a portfolio is one way to deal with this kind of volatility--paring back when it becomes too large but also adding to it again when it becomes too cheap. This is something we have done and will continue to do.

Nvidia’s greatest asset may be its founder, Jensen Huang, but even great founders can make mistakes. History has shown that companies can have multiyear runs based on their domination of a particular industry—like Apple and Alphabet. But they can also lose focus and fall from grace, like Xerox or Polaroid. Owning a great growth stock for a long period of time is hard. It requires continual vigilance of one’s own personal financial goals and paying attention to what a company says versus what it actually does.



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