Please note this email was written on July 23rd, prior to the recent events in the market.

In my last email, I stated that I would contact you once I had completed the semi-annual rebalance in the portfolio. That has now been completed, so I would like to update you on the changes that were made.

Executive Summary:

1.
2. Advanced Micro Devices (AMD) was replaced with Applied Materials (AMAT), and the other six stocks remain unchanged (AMZN, GOOGL, MMC, MRK, RSG, and WMB).
3. I replaced the large-cap growth and value mutual funds with actively managed Exchange-Traded Funds (ETFs), both from Capital Funds. They are the Capital Growth ETF (CGGR) and the Capital Dividend Value ETF (CGDV).
4. The cash weighting in the portfolio remains elevated at 20%, with an approximate yield of 5.15% (yield subject to change).[1]
5. I reduced the overweighting of the growth component in the portfolio by shifting to more equal weighting between growth and value.
6. The international holdings remain unchanged, as do the fixed-income holdings.

Overall, only a few changes occurred during this last rebalance. AMD's technical rating dropped below the acceptable score[2] to retain it in the portfolio, so I found a replacement. I am pleased with the addition of Applied Materials. If you aren't familiar with this company, they are involved in the semiconductor industry. However, they aren't a computer chip maker. Instead, they make the equipment that provides materials engineering solutions, manufacturing equipment, services, and software for the semiconductor, display, and related industries.[3] When looking at the financial metrics for the company, I believe we are picking up this stock with a very reasonable valuation.[4] The other stocks in the portfolio continue to perform well, with AMZN, GOOGL, RSG, MMC, and MRK all at or have recently made all-time highs.[5]

The most significant change is the replacement of two mutual funds with actively managed ETFs. Mutual funds and ETFs are essentially a basketful of stocks.[6] Most things in life have pros and cons, and the same holds true for mutual funds and ETFs. One of the pros of using mutual funds in a portfolio is that a portfolio manager makes buy and sell decisions within the fund.[7] The assumption is that the portfolio manager is skilled in identifying promising opportunities and knowing when to sell investments at the right time. One of the cons of mutual funds is that the internal fees can be high.[8] The cost to run the funds isn't cheap! Additionally, when a portfolio manager sells an investment within a mutual fund, those capital gains can be passed along to the individual investor in the fund in the form of long or short-term capital gains.[9] Sometimes, those gains can be significant, so the potential for a large tax liability exists. This scenario happened in the fall of 2021 when the tech bubble started to pop.[10] Many tech portfolio managers sold their stock because they thought it was the right thing to do, which resulted in significant capital gains distributions at the end of the year for the individual investor.[11] With ETFs, the opposite exists regarding the pros and cons. One of the main pros of using an ETF is that it is very cost-efficient because, generally, it does not have a portfolio manager actively managing the ETF holdings, which, at the same time, can be a con of using an ETF.[12] Another pro of using ETFs is that

because of the fund's legal structure, they never pay out any capital gains or losses at the end of the year.[13]

Given that background, I am excited to relay to you that I may have found an opportunity to get the best of both worlds between the pros of using mutual funds and ETFs without any of the mentioned cons involved. It almost sounds too good to be true, right? The Capital Group brought to the market back in 2022 several actively managed ETFs, two of which I have added to the portfolio.[14] These ETFs are situated in the large-cap growth and large-cap value space and replace the large-cap growth mutual fund and the large-cap value mutual fund. With this switch, I can reduce the internal fees by .5% in each case.[15] Also, I have avoided potential large capital gains distributions in the portfolio from the two mutual funds. The large-cap growth fund was the Columbia Global Technology Growth fund, and at some point in the future, that fund could see some hefty capital gains distributions because of the growth of the fund.
Tech stocks have had an incredible run over the past years, and valuations in that space are getting pricey.[16] At some point, the market may see a rotation out of those tech stocks into more reasonably priced stocks, i.e., value stocks.[45] That may be happening now[17], or it may take a year or two for that rotation to occur. Still, I believe it is coming, so I decided to front-run that scenario and get out of the tech mutual fund and into a large-cap growth ETF that is actively managed. So, the portfolio still retains active management but at less cost and with better tax efficiency.

The rotation mentioned above could be underway right now[18]. The week of July 15th saw the worst week for the NASDAQ and the S&P 500 since April, with three straight days of losses.[19] As I said earlier, tech stocks seem to be priced for perfection, and any shortcomings with Q2 earnings reports could cause a correction in the markets.[20] As I write this on July 21st, we have not seen any Magnificent 7 stocks' earnings report. Given their incredible run this year, these companies have high expectations, and investors will scrutinize their respective earnings releases.[21] With all of the hype surrounding AI, any talk of slowing revenues or earnings could be cause to take profits, which could then be a catalyst for a market correction of 5%-10%, as I mentioned in my last email to you earlier this month.[22] I believe that some of the air needs to come out of the technology stocks, so I reduced some of the exposure in tech and rotated that money into more value-oriented holdings.

So far, that seems to be the right move, and I can tell that from looking at the sector bell curve from my technical data.[23] When the market was making new all-time highs throughout June and into early July,[24] the underlying health of the market was questionable.[25] The sector bell curve, which tracks forty different sectors, was very suspect, with twenty-three sectors considered unfavorable and only four favorable.[26] Of those forty sectors, thirty-four were negative and only six positive.[27] Fast forward to July 19th, and we have seen an incredible turnaround, with sixteen sectors now rated as unfavorable and eleven favored.[28] There are now five sectors considered negative and thirty-five considered positive.[29] That is a nearly a 180-degree turnaround in a very short period! Don't get too caught up in what constitutes positive/negative or favored/unfavored. If you want to go deep in the weeds with me on that, I am more than happy to go over that in more detail in a one-on-one with you. Suffice it to say that you want to see more favored and positive sectors than unfavored or negative sectors.

The broadening in participation[30] is a welcome development in the markets to see more sectors moving in the right direction immediately before the vast majority of Q2 earnings are released.[31] It seems that Wall Street expects to hear some good things from U.S. corporations, and the participation on the upside is spreading out to more and more stocks.[32] Money is starting to rotate out of tech stocks and into the other unloved stocks of 2024.[33] Semiconductors, in particular, had a rough week of July 15th with their worst plunge since 2020,[34] while the Russell 2000 (small caps) finally showed signs of life.[35] Small caps tend to do well when interest rates are going down,[36] and currently, the Fed Funds Futures are pricing in a 91.7% chance of a .25% rate cut in September.[37] If the Fed does move in this direction, we could see small caps finally break out of their nearly two-year trading range to the upside[38], which is definitely a welcome development for the market.

Additionally, if there is a rate cut in September, I would anticipate that short-term interest rates will start to move lower in August in anticipation of the September rate cut.[46] If that plays out as expected, then there is a good chance we could see the one risk chart that flipped negative back in April flip to positive, thus giving me the go-ahead to increase the equity exposure within the portfolio.[39] There is much conjecture there, but that is the working hypothesis.

As a result of the semi-annual rebalance, the portfolio is currently in a very healthy state.[40] The first-half performance numbers have been solid, and given the weight of the evidence as it stands today,[41] we could see even more gains as the year progresses. There is much time between now and then, and many things can derail the positive outlook. However, with inflation trending down[42], the economy is still humming along,[43] and with possible interest rate decreases on the horizon,[44] things look good. Let's hope they stay that way!

As always, if you have any questions or need clarity on anything above, please do not hesitate to contact me. I hope you are enjoying the summertime with family and friends. I look forward to catching up with you in my next email sometime in September, assuming nothing major occurs during the interim.

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