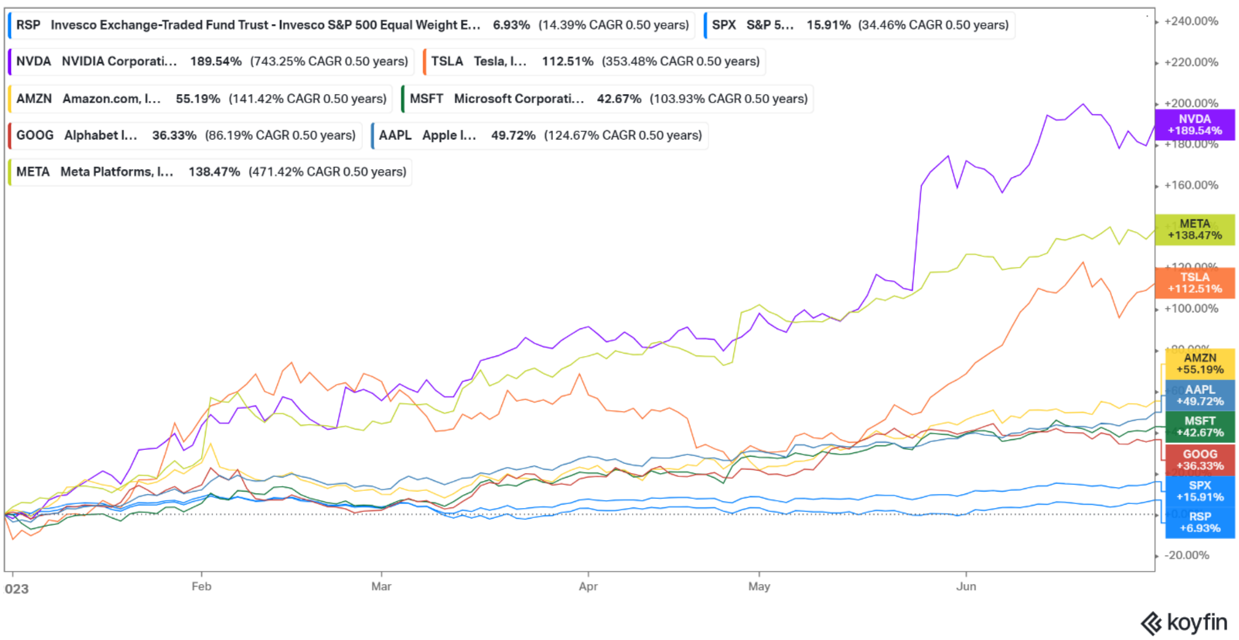
O'KEEFE STEVENS
ADVISORY, INC.

Q2 2023 July 14th, 2022

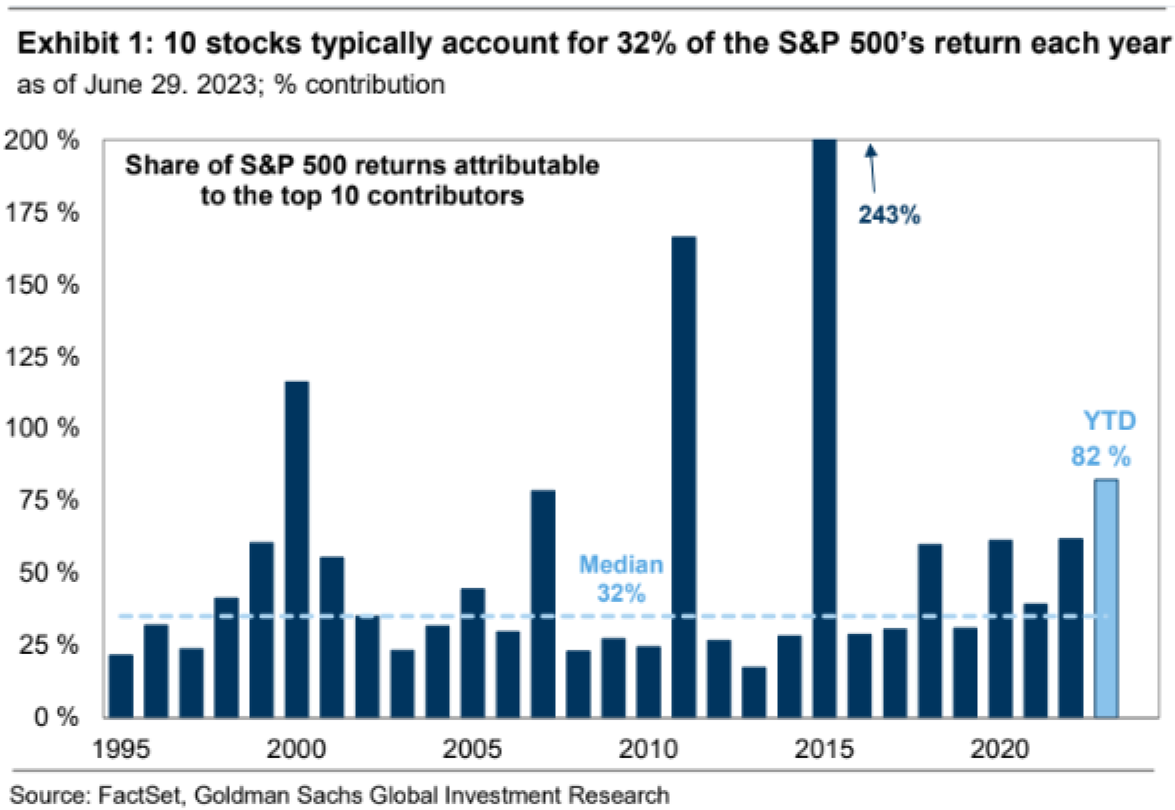
Same Story, Different Year

Tech dominated the first half of 2023, with the seven largest components of the S&P(AAPL, AMZN, GOOG, META, MSFT, NVDA, TSLA) up between 36% and 189%. These staggering moves for large-cap companies, most of which benefit from the proliferation of Artificial Intelligence. While the S&P 500 is up ~16% year to date, the S&P 500 equal-weighted index is up just under 7%.



According to Goldman Sachs Investment Research, the top 10 performing stocks average 32% of the S&P 500's returns. Year-to-date, the top 10 stocks accounted for 82% of returns. With this the case, the return dispersion of S&P is broad, ranging from NVDA up 190% to AAP down 51%. Information Technology and Communications unsurprisingly led the way, up 40.8% and 37.4%. While artificial intelligence is in the early years of adoption, we suspect much of the potential gain of AI is well reflected in prices. Trading at 36x TTM earnings, the reinvestment rate and ROIC demanded from these starting valuations are high. Having an alternative to invest in (bonds) for the first time in a decade demands greater certainty from investors regarding the long runway required for these investments to generate satisfactory returns. While we commend those attempting to jump over the 10-foot high bar, we remain patient and disciplined, looking to purchase businesses with far lower expectations.

Tech companies will not be the only beneficiaries of AI. Efficiency improvements at industrial companies, automating previously labor-intensive activities, and using predictive algorithms to adapt at an accelerated pace. While current products are relatively new, as outlined in the book "Genius Makers: The Mavericks Who Brought AI to Google, Facebook, and the World" Cade Metz details the origins of artificial intelligence. Those interested in learning about how we got here today should read this.

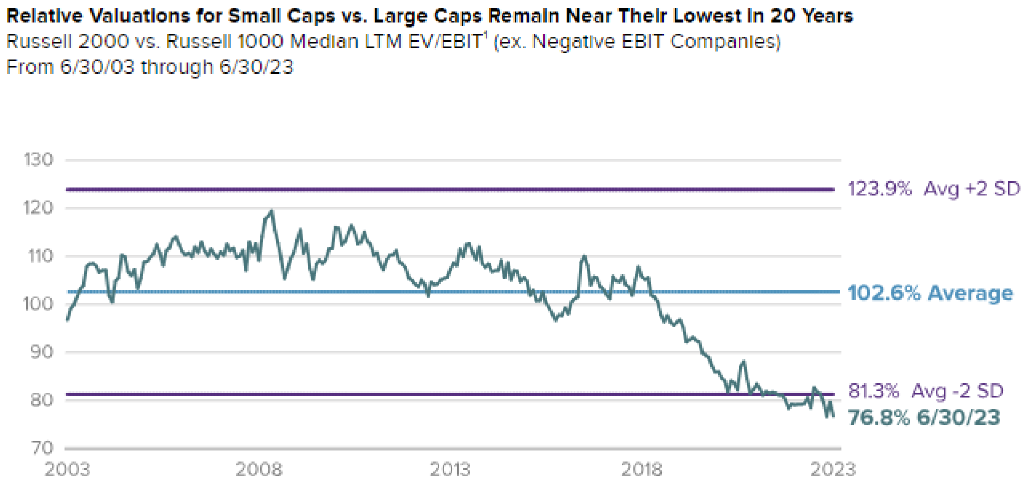


Berkshire Hathaway Annual Meeting

In May, Peter and I had the opportunity to attend the Berkshire Hathaway Annual Meeting and the GuruFocus conference. As a "first time, long time," it was incredible. The knowledge to gain and connections to make are endless.

At the GuruFocus conference, we heard several presentations from renowned and experienced investors, including Alex Fitch & Robert Bierig (Portfolio Manager at Oakmark Funds), Bill Smead, Jonathan Boyar, and others. Each brought a twist on the traditional value investing style and different topics and ideas to research. We found a recurring theme in several presentations. Although this was considered the mecca of Value Investing, the portfolios of many speakers bore a stronger resemblance to higher quality, well-known brands, with a focus on large caps. While Peter and I sat there, puzzled about why this was the case, we drew the same conclusion. Smaller, off-the-beaten-path names are likely cheap if most market participants focus on medium to large capitalization businesses.

The chart below compares the relative valuations of the Russell 1000 (Largest 1000 securities in the Russell 3000) compared to the Russell 2000 (smallest 2,000 companies in the Russell 3000) shows a similar picture. The relative valuation of small caps to large caps is almost the cheapest ever. While we understand smaller companies typically are at higher risk, the dramatic valuation gap is likely more than reflecting this risk. If the world looks at the same high-quality, large-cap names, we prefer to look at smaller names with less attention.



[1] *Last twelve months Enterprise Value/Earnings Before Interest and Taxes.*
Past performance is no guarantee of future results. Source: FactSet, Royce Associates

New Ideas

Sphere Entertainment (SPHR)

We initiated a new position during the quarter in Sphere Entertainment. Building on the previous paragraph, Sphere is a recent remain-co after spinning off MSG Entertainment. This $1B market cap, $2B Enterprise Vale business is **small**, **uncertain**, and **underfollowed** and is precisely the type of investment we seek. The unique, state-of-the-art entertainment venue has 17,500 seats, 23 VIP suites, and the most advanced sound and highest resolution screen spanning three football fields. The Sphere illuminated the world for the very first time on July 4th. It's challenging to get a genuine appreciation of the breadth and scale of this engineering masterpiece. The exterior is a 580,000 SF fully programmable LED screen. Expect this to be the Time Square of Las Vegas.

https://finance.yahoo.com/news/hello-world-sphere-illuminates-entire-120000694.html?.tsrc=rss

Small – With a $1B market cap and $2B enterprise value, the potential investor base is small institutions and retail investors.

Uncertain – Announced in 2018 with an expected finish date in 2021, cost overruns of $1.2B, supply chain challenges, and project shutdowns during covid pushed the open date to September 2023. It was initially estimated to cost $1.2B. However, the expectation is that it will now cost $2.4B. Assuming no more delays, U2 will open the venue in September. The economics of the venue are unknown. U2's performance and in-house production "Postcard from Earth" are the only shows announced. Given the delays, a litany of shows will get announced when the Sphere officially opens.

Underfollowed – Given the recent spin-off and unknown business economics, the number of analysts following this name is minimal and likely overstated as analysts get up to speed on the separated entities. As the venue stabilizes, we expect more coverage and attention will re-rate the stock closer to its fair value.

You can read our full write-up on Seeking Alpha here.

Bowlero Corp. (BOWL)

One aspect of investing often overlooked relates to analyzing businesses where you have a superior understanding of the product or service. One industry this pertains to us is the Bowling Industry. From bowling at an early age, to collegiate bowling, to working at an alley, I can't think of another business where I better understand the trends and economics than the bowling industry.

Bowlero came public via a SPAC in 2021. BOWL is among the few SPACs trading above the initial cash shell value. The bowling alley roll-up story is an easy sell. Acquiring dozens of poorly operated alleys from mom and pops every year, improving operations, and using the improved cashflows to acquire other centers. The high fixed-cost nature of the business results in high incremental margins (almost 100%) for every additional game bowled. This operating leverage, however, cuts both ways. With unemployment rising, economic stimulus cutoff, student loan payments returning, and higher mortgage rates. The disposable income individuals once enjoyed is likely declining. In addition, bowling is structurally a declining sport, even though management says otherwise. From accounting games, including PIK interest on preferred stock, operating/financing lease adjustments that overstate margins, and insider sales, all combined with a demanding valuation, make this an attractive short.

You can read the full write-up on SumZero here. We are happy to send the write-up and model for those without access.

Podcast

In April, I chatted with Bryce and Ren of the Equity Mates Investing Podcast. We covered various topics from my 2023 predictions, investment philosophy, and approach to teaching at Nazareth College (now Nazareth University). You can find the podcast on Spotify & Apple under the Equity Mates Investing Podcast: Expert – Dominick D'Angelo.

Portfolio Top 5 Holdings

At the end of Q2, our top 5 holdings represented ~40% of assets, with NVDA representing almost 24% of the portfolio. The remaining four include QCOM, AMGN, BKRIF, and GLW. The concentration at the top of the portfolio dramatically increased due to the 189% YTD performance from NVDA. We expect the concentration in NVDA to decline over the coming quarters as we write options against the position.

Regards,

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