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THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

Magnificent Seven Could Continue to Dominate for a Long Time

NORM CONLEY is the Chief Executive Officer and Chief Investment Officer of JAG Capital Management. He entered the investment industry in 1994 and joined JAG in 1999. Mr. Conley oversees JAG's managed equity and fixed-income strategies, he is the controlling shareholder of the firm, and he serves on JAG's Senior Management Committee. Prior to joining JAG, Mr. Conley spent three years as a naval officer and five years with a global investment firm. He earned his B.A. from the University of Notre Dame while on a Naval ROTC scholarship and earned an MBA in Finance from the Olin School of Business at Washington University in St. Louis. He has served on the Board and Executive Committee of both Good Shepherd Children & Family Services and Chaminade College Preparatory School, and is a longtime member and past Chairman of the St. Louis Chapter of the Young Presidents' Organization (YPO).

SECTOR — GENERAL INVESTING

TWST: For the benefit of readers, give us an introduction to JAG Capital Management.

Mr. Conley: The roots of our firm go back all the way to 1945. We've been known as JAG Capital Management since 2013. We are a boutique registered investment advisory firm that manages investment portfolios for institutions, financial intermediaries, and individuals and families around the country.

We're a long-only manager and we actively manage growth equities and intermediate fixed income strategies for those three types of clients. We're based in St. Louis, Missouri.

TWST: What is most important to know about your investment philosophy overall?

Mr. Conley: I'm the third CEO of the firm since the roots back in 1945, and our investment philosophy is largely due to our long history serving the investment needs of women's religious institutions.

Many religious orders established their presence in the United States in the 19th Century, and almost all of them had very humble beginnings. But then as we got into the mid to latter part of the 20th century, a small but growing number of religious communities had accumulated meaningful amounts of long-term assets.

JAG's founder realized that these clients really had two primary goals with their financial assets. One, they needed to generate some dependable cash flows to help support their missions. Secondly, they wanted to compound their assets over time, to support the very long-term growth of their missions.

Those twin goals form the bedrock of our firmwide investment philosophy. On the equity side, we're growth investors. We're trying to build and maintain a focused portfolio of leading companies that are going to grow faster than their peers and the broader market, and ultimately, compound their value over time.

And the fixed income side is designed to do what fixed income is supposed to do: provide a lower volatility stream of reliable cash flows.

To use a baseball analogy, we manage our bond portfolios to hit singles and doubles rather than home runs or grand slams. Our approach to bonds is unapologetically old-fashioned and intentionally boring.

When fixed income is exciting, that's usually not in a good way. Some fixed income strategies were very exciting in 2022, especially those that were heavily positioned in long duration bonds. That's not for us.

My immediate predecessor as CEO was my father-in-law, who passed away about three and a half years ago. He purchased the firm in 1988, from Joseph Glynn, our founder. I took over as CEO in 2008 — great timing — just in time for the biggest financial crisis since the 1930s.

TWST: Tell us a bit more about the research and stock selection process.

Mr. Conley: We do most of our research internally. We generate our initial ideas with a multifactor model that filters and ranks our investable universe, which is about 700 securities. We typically source our ideas from the top 20% scores of our factor model.

We maintain a Focus List of roughly 80 securities, which includes our current holdings of between 30 and 40 stocks. That means there are between 40 and 50 candidates for portfolio inclusion at any given time.

On that subset of companies, we perform ongoing fundamental research, which involves reading company filings, listening to earnings calls, monitoring company presentations, reading trade literature, and digesting external research from both sell-side and independent researchers.

Companies on our Focus List are also subjected to our own proprietary qualitative assessment tool. We think this is somewhat unique to our firm. We call it a Q score, and it's derived from an 18-question survey that the covering analyst has to answer.

That allows us to evaluate how we feel about the company's addressable market, the company's competitive moat, the management of the company, their tone of messaging, the momentum of the company, and how various stakeholders regard the company.

After those three first steps — idea generation, which again we do with a quantitative factor model that ranks and filters securities, then the fundamental research, and then we follow that with our own qualitative assessment — we end up with a small number, usually between three and five securities, that are added to our bullpen.

In our view, this is probably for good reason. Furthermore, we are not at all certain that this is likely to change anytime soon.

We own all these companies: **Microsoft** (NASDAQ:MSFT), **Amazon** (NASDAQ:AMZN), **Apple** (NASDAQ:AAPL), **Alphabet** (NASDAQ:GOOG) the old Google, **Meta Platforms** (NASDAQ:META) the old Facebook.

They are extremely well capitalized, with enormous cash balances and little to no debt. Importantly, they also employ some of the best talent in the world and have significant competitive advantages in their served markets.

And, as we've seen just this year with the artificial intelligence boom, these companies at least so far look like they are likely to grab much of the economic benefits that will be derived from artificial intelligence.

"One of them is Eli Lilly, the United States-based biopharmaceutical company. It's one of two companies globally that have brought to market and received approval for treatments that both treat diabetes and, as we've found out over the last 18 months, have significant positive impacts on obesity, meaning they assist in material weight loss among most patients."

We think of the bullpen as very similar to a bullpen in baseball: There is a starting pitcher out on the mound, and hopefully that starting pitcher can go into extra innings and never need a replacement, but that's very rarely the case.

Often pitchers get tired, and the manager and the pitching coach are watching that closely. They usually have a couple of guys in the bullpen warming up. If those guys in the bullpen are throwing heat and the starting pitcher is maybe losing his fastball or curve and there are too many hits being made by the batters, those guys in the bullpen are going to impose pressure on the guy who's on the mound.

That's exactly how we think about our bullpen — those three to five companies that we hold in the bullpen are imposing constant pressure on our existing holdings. "Put me in the game, coach." They're ready to go; from our perspective, they're fully vetted. And so, when investment discipline drives a trim or a sale of a position, we always have a replacement ready to go.

That's how we build the portfolio, which we view as being focused but diversified across companies, industries and sectors. We think with 30 to 40 holdings we can be both focused and diversified, but still always have our best ideas in the portfolio.

TWST: Can you give us a few examples of favorite investment ideas right now?

Mr. Conley: As a large cap growth manager, I'd be remiss not to mention the structural changes to market structure that have evolved since the last time I spoke to *The Wall Street Transcript* roughly 10 years ago. To be put simply, the market has become much more concentrated than it has been for most of the last 30 years.

This really started happening in 2016, and it's happened to an even greater extent ever since — and that's the real domination position of mega cap technology stocks, what some call the Magnificent Seven. These companies have become increasingly heavily weighted within the major indices like the S&P 500 and the Russell 1000 Growth Index.

1-Year Daily Chart of Microsoft Corporation

Chart provided by www.BigCharts.com

I don't think my view regarding these companies is particularly unique, especially among large cap growth investment managers.

We do own some companies that are maybe a bit more idiosyncratic among our peer group. One of them is **Eli Lilly** (NYSE:LLY), the United States-based biopharmaceutical company. It's one of two companies globally that have brought to market and received approval for treatments that both treat diabetes and, as we've found out over the last 18 months, have significant positive impacts on obesity, meaning they assist in material weight loss among most patients.

It's been amazing to watch over the last 18 months as those companies continue to gain more approvals for more indications, and it's been quite disruptive in the health care market.

Another company that we like a lot is **Deckers Outdoor** (NYSE:DECK). At approximately $17 billion in market value, we think **Deckers** is still underappreciated by some investors. Although

most people are not familiar with the company, many are aware of their biggest brands: Hoka and Ugg.

Ugg boots have been around for a long time, but the company has completely revitalized this brand with new styles and formats over the past few years. Hoka is, depending on who you talk to, the fastest or second fastest growing athletic shoe brand — running, walking, hiking — in the United States.

We really like what the company is doing. They have an approach to inventory management where they are intentionally maintaining a level of scarcity across their brands because they want to maintain a healthy and growing margin profile and they do not want to have their brands be discounted.

That's in contrast to many apparel companies who are more focused on top-line growth, which can penalize profit margins and sustainability of brand heat.

Trying to predict the impact of macro developments on the kinds of stocks or bonds we own is not our game. Macro is going to do what it's going to do. It's interesting, it's fascinating, but very, very difficult to forecast accurately. We leave that to others.

I'm coming up on 30 years of experience in the investment industry, and for most of that time the major indices were not heavily concentrated in these Mag Seven or mega cap tech stocks. When concentration started to become a thing in 2016 and 2017, because it had not been part of my experience in my own investing career, I was slow to recognize that this could persist for a long time.

And I think part of why I did that is because, though I had 20-years-plus of experience at the time, my historical frame wasn't broad enough to include periods like the 1950s, 1960s, 1970s, when you really had a generation in which there was very heavy — in fact at certain points much heavier — concentration in the S&P 500 than currently exists.

"It's hard to have that spit out of a formula, but we really want companies that have large addressable markets — ideally large and growing addressable markets — for their goods and services, that have leadership positions — number one or number two in their markets — with defensible moats, and across all of our sectors that's what we're trying to find."

We currently own 30 stocks, so I could talk your ear off on most of them. But I would say generally we really want to invest in the correct side of creative destruction. We want to be on the side of innovation and do our best to avoid owning companies that are being disrupted.

That's something that we get into when we think about companies qualitatively. It's hard to have that spit out of a formula, but we really want companies that have large addressable markets — ideally large and growing addressable markets — for their goods and services, that have leadership positions — number one or number two in their markets — with defensible moats, and across all of our sectors that's what we're trying to find.

TWST: As you do your research and portfolio management, and also as you observe other investors' behavior, are there any particular themes or trends that stick out for you, whether areas of opportunity or things that make you cautious?

Mr. Conley: There's always something to worry about in the markets. Occasionally, the worries come true in the form of a painful bear market. 2022 was an example of this. It was an extremely difficult year for both stocks and bonds, and it's been followed this year by quite a strong year for stocks, and a much better year for bonds.

We don't claim to have any special insight into the path of interest rates over the coming few years, but we are confident that the magnitude of short-term interest rate increases are probably behind us.

Bookending 2022 and 2023 is just another reminder to all of us that nobody really knows what is going to happen in markets over the short- to intermediate-term. Very few investors predicted what would happen in 2022 to stock and bond prices. Similarly, almost no one expected 2023 to be such a strong year for the S&P 500.

We don't make any claim to know what the market or macroeconomic backdrop is going to do in any given quarter or year.

1-Year Daily Chart of Meta Platforms Inc.

Chart provided by www.BigCharts.com

You had companies like AT&T that for decades had huge weightings in the market. Similarly, General Electric and General Motors were very heavily weighted for decades until the 1980s and 1990s.

By the time I came on the scene in 1994 in the industry, and then to this firm in early 1999, except for some brief periods right before the tech bubble burst, concentration was really not an issue. The market was more balanced.

I've already criticized myself; I think I was late to recognize this. I think that some folks out there may still be having a little bit of a blind spot like I did until probably the last couple of years. But I would say that this could persist for quite a long time.

It doesn't mean that **Microsoft**, just for example, and which happens to be our largest holding right now, is going to necessarily grow earnings faster than every other company in our portfolio. But it's really

a two-sided coin. It's the stability or the permanence of some measure of earnings growth and the competitive moat that they have.

The moat is probably much wider and deeper for a company like **Microsoft** than even I as a longtime holder would have recognized five years ago.

These companies will have their ebbs and flows. The stocks will go up, they will go down. But by and large, in the last three to five years they have tended to be less volatile than smaller competitors or smaller peers in the same or similar industries.

That's something that has been different in the last seven, eight years than the first 20-something years of my career, and I don't see any obvious reasons why this must change anytime soon.

I think that we could be in a period like the middle to latter part of the 20th Century. Although we no longer have true monopolies like AT&T, we do have what I would say are functional or de facto monopolies.

And, of course, that's not what has happened. Our economy and successful companies have created an enormous amount of wealth over the last couple of hundred years. I generally try to remind folks that whatever is on the TV or on the internet in terms of current events, whether it's good stuff or bad stuff, it is already incorporated into asset prices.

That's a hard concept for most people to grasp, particularly if you think back over the past few years. There have been some truly tragic, terrible things that have arisen in the world. We have a land war in Europe for the first time since 1945. Looking back a little further, we had a global pandemic. And more recently some truly awful things have occurred in the Middle East.

It's almost inconceivable to us as humans to think that betting on the long-term success of innovative and growing companies is probably the right bet, but it is.

"Although we no longer have true monopolies like AT&T, we do have what I would say are functional or de facto monopolies. For example, Alphabet's Google has more than 80% market share of the global desktop search market. This is close to a monopoly. Similarly, Microsoft's office productivity software has more than 80% market share."

For example, **Alphabet's** Google has more than 80% market share of the global desktop search market. This is close to a monopoly. Similarly, **Microsoft's** office productivity software has more than 80% market share. I would characterize this as a functional monopoly. I could go on. **Amazon** dominates e-commerce in the United States. **Meta's** Facebook and Instagram are leaders in social media.

I'm going to err on the side of assuming that these larger companies will continue to be dominant in their markets for a long enough period to matter to most investors.

TWST: I'm curious what questions or concerns you are hearing from clients these days?

Mr. Conley: Well, a lot of people are concerned about concentration in the indices and what I just discussed, and I give them a variation of the answer that I just gave you. Contrary to what I would have said 10 years ago, I don't necessarily think that these large companies will be usurped by smaller companies anytime soon. I think that's potentially important for diversified investors to grasp.

I think it's hard to avoid these dominant technology leaders. It could be an uphill battle for quite some time for long-term investors who fail to maintain some meaningful exposure to this part of the stock market.

It's very typical, at almost every point of my career, to get the standard, "What if X happens? What if Y happens? There's this terrible thing going on in the world, or this terrible thing that could happen, why do I want to own any stocks at all?"

The fact is, probably ever since there's been modern financial markets — which goes back to the buttonwood tree in Manhattan, the first stock exchange, well over 200 years ago — every single day there have been stocks trading, there's been probably no shortage of logical reasons that you should be 100% in cash.

1-Year Daily Chart of Deckers Outdoor Corp.

Chart provided by www.BigCharts.com

Now going on 30 years, I've seen a fair amount. I've seen two 50% down bear markets, I've seen a lot of 20% and 30% drawdowns, and I've seen the great financial crisis.

Having seen the worst that markets can throw at investors, I continue to believe that it simply doesn't pay to stay too pessimistic for too long. It also doesn't pay, in my estimation, to try to time one's exposure. It's just impossible to do with any accuracy over any meaningful period.

About market concentration, you read articles about, well, these seven stocks are driving most of the returns of the S&P 500, what about the rest of the market? Maybe it should be the S&P 7 and the S&P 493? But that's just the way markets are. They change over time.

We have had periods that persisted for a very long time of heavy concentration in the major indices, it just happens to have not been over most of our careers, even those of us who have been around 30 years.

You must broaden your historical frame to look back to other periods in modern postwar history. I think this is one of those periods where we could see the rich get richer and the big get bigger for a meaningful amount of time into the future.

TWST: In the recent past, what have been the main contributors to your performance? And on the other side of that coin, what have been the main detractors?

Mr. Conley: I'd say we've done well over the past year, and done well over our very long-term history. If there's a mistake of judgment, it's mine. If there's a successful outcome, that's attributable to the team.

I was slow, as I said earlier, to recognize how things are different in terms of the dominance of a relatively small number of companies. Over the last 18 months we have gotten religion on that front, and those companies have been substantial contributors, as well as what I think some people are starting to talk about — that next layer of very large companies, many of which are technology oriented, that are not quite mega cap, but have performed quite well.

For us, that cohort would include companies like **ServiceNow** (NYSE:NOW), **Fair Isaac** (NYSE:FICO), and **Uber** (NYSE:UBER), which is one of our top 10 holdings. It's a large company; it's "only" a $115 billion market cap.

We purchased **Uber** earlier this spring for the first time. We think that they are in the process of inflecting to being quite profitable as they rationalize their business model, and we like that company a lot.

So, those have been some of our better performers in the last couple of quarters.

In terms of areas that haven't helped as much, I talked earlier about the disruptive effect the innovation in anti-obesity drugs is likely to have. When you think about some former holdings of ours, we really liked the companies a lot, though it's very likely that their ultimate addressable markets will be somewhat smaller than we would have believed a couple of years ago.

What I mean by that is a company like **DexCom** (NASDAQ:DXCM). They specialize in medical devices that help patients manage and treat diabetes. The stock has recovered somewhat recently in the last month or two. But for some of these companies, there's very likely going to be fewer people that need their devices over a three- to five- to 10-year horizon, and as growth investors, that can be meaningful.

So we're a little bit cautious on much of the health care sector as these anti-obesity treatments become more prevalent.

I think overall it's wonderful for society if these continue to gain steam and are prescribed to more people. It's likely we'll overall be healthier. We'll have less dependence upon the health care system. But as positive as that is, there are going to be some losers.

And so, we're a little bit more cautious than we would have been even a year ago on certain areas of the health care sector that develop either drugs or devices that treat some of these comorbidities that could decline in their prevalence coincident with broader distribution and prescription of these GLP-1 anti-obesity drugs.

TWST: Despite, as you noted, not being able to predict the future, do you want to wrap up with your outlook for 2024?

Mr. Conley: Overall, cautiously but solidly optimistic looking forward, especially from a holistic perspective.

We've spent most of the time talking about large cap growth. But for investors, particularly savers, those on a fixed income, and even institutions like pensions and not-for-profits, something wonderful has sprung out of what was really a rough 2022.

It's been going on 16, almost 17 years that bonds have not been able to fulfill their two primary goals. They've been able to fulfill one of them, which is — 2022 being the exception — bonds tend to be less volatile than stocks. But they hadn't been able to fill their additional role of producing dependable cash flow or yield.

That's changed, and we think that many people still don't recognize that. We think that's a really great thing for those who are able to lend money, which is what you're doing when you're buying a bond.

That right there is one reason for long-term diversified investors to be optimistic, because for the first time in quite a long time your fixed income allocation can do its job, and therefore, your overall portfolio can have a bit smoother ride if you include some bond exposure.

Regarding stocks, we are cautiously optimistic about 2024. We don't see a lot of exuberance, which is a good thing because broad exuberance is historically a sign that the market may be nearing a near- to intermediate-term top.

On the contrary, we see a lot of concern, probably in large part due to what's going on in the world geopolitically.

Also, we're coming up on what's going to be, from whatever end of the political spectrum you occupy, a crazy election year in the United States. There's a fair amount of consternation out there; we think that this is largely discounted in stock prices.

Meanwhile, earnings estimates for both 2024 and 2025 are starting to tick up, and you can see, at least we can see, the intermediate term outlook being supportive of decent returns for stocks.

So, putting it all together, diversified investors with allocations to both equities and fixed income should tilt optimistically. Given the change in interest rates that occurred over the past 18 months, this might be holistically one of the better periods to be an investor.

In contrast to much of the past couple of decades, the ability to earn decent returns from bonds could allow investors to take a bit less risk in their portfolios, without giving up too much of their prospective returns. We think this is a good thing.

TWST: Thank you. (MN)

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