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# Avago Technologies: The Playbook for Success

**Dan Rohinton,** Vice-President, Portfolio Manager, Global Dividend

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"The semiconductor industry is a mature industry. The days of outsized technological improvement are in the rearview mirror, which is why we are focused on efficiency." -My meeting notes with Avago CEO.

These words, or some version of them, were shared by Hock Tan, the legendary CEO of Avago Technologies, in nearly every meeting. His viewpoint reflected a future where the semiconductor sector evolved into a slower-paced, mature industry that demanded a fundamentally different approach to management marked by frugality and discipline. Under Tan's steady leadership, Avago continued to deliver on this playbook time and again across multiple end-markets and capabilities.

Executing the 80/20 Rule: Avago's commitment to cost discipline is evident every quarter, displaying exceptional margins across the board. This approach is a top-to-bottom initiative driven toward building a clear set of products and capabilities where Avago can wield a competitive advantage and technological leadership over peers in the category. In addition, an intense focus is placed on managing a diverse set of customers by narrowing the attention to the most substantial and profitable relationships for the company. In essence, Avago has adopted the 80/20 rule for the technology world, aiming to cut inefficient spending which usually originates from a long tail of diverse clients who are not significant enough to deliver attractive margins over time. Today, after years of adhering to this playbook, Avago boasts a 51% free cash flow margin, second only to Nvidia in the semiconductor world, and has some of the highest margins of any company.

There is much to be said about Avago's early venture into custom ASICs and the string of successful acquisitions that morphed Avago from a small player into a semiconductor giant. It's incredible how Hock Tan seemed to predict the corners of the somewhat cyclical business and transform it into a secular grower. But it's fascinating to conclude with the fact that the $600 billion behemoth, Avago, was built under a seemingly incorrect worldview. Hock’s opinion of semiconductors, ultimately proved to be wrong (so far)!

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# TD Bank: Made In Canada, Should’ve Stayed In Canada?

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In 2008, Canadian banks found themselves in a fortunate relative position, boasting a robust foundation as the financial crisis unfolded. While US banks were under tremendous pressure, the opportunity arose for them to diversify further and make long-term strategic bets in the US. TD Bank made a particularly bold move by purchasing Commerce Bancorp for a significant price tag of $8 billion in 2008.

Sixteen years later, it's worth reflecting on whether this aggressive US growth strategy has been a positive experience for shareholders?

The TD USA franchise is now the 7th largest bank in the US by deposits. However, shareholders who funded the growth through foregone dividends and buybacks are left with a franchise that continues to demonstrate mixed profitability and returns. The recent earnings results reported by TD show a net income of $907 million in Q1 of 2024, only slightly above the $901 million TD earned in Q3 of 2017. The return on equity (ROE) in Q1 of 2024 was 8.3%, similar to the figure in Q4 of 2016. It's important to note that this is before including litigation and regulatory issues, including recent problems related to anti-money laundering violations that the company has been forced to grapple with over the years.

These numbers can be examined in isolation, but it's enlightening to compare them to TD's Canadian banking division, which delivers a sky-high ROE of 35%. Across nearly every investor-relevant metric, TD Canada outshines TD USA significantly. What's even more surprising is that the organic revenue growth for both Canada & US has been similar in the last two years. This is particularly noteworthy as such growth was arguably one of the primary reasons for TD's expansion into the US. The usual rebuttal—that "Canada doesn’t have any growth and market share left to take" seems less compelling if both subsidiaries grow at the same pace.

While there is a long history of Canadian companies finding success around the world through growth and diversification initiatives, over a decade and a half later, it is up for debate whether the US expansion strategy at TD has served investors better than a Canada-first focus with a consistent program of buybacks and dividends to recycle the significant earnings windfall. TD Canada is considered one of the best banking assets in the world, TD USA is just another regional bank.

As investors in TD, it’s important to reflect on the opportunity cost of how profits are invested. Consider an alternative parallel scenario with only TD Canada without the US step-out. This pure-play franchise would have likely delivered an even better total return for shareholders than the 10% per year since 2008 TD actually generated. It’s a reminder that there’s no shame in a 100% payout ratio of dividends and buybacks, especially for the money printer that was and still is TD Canada.

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# Nvidia: The Magnificent One

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"Accelerated computing and generative AI have hit the tipping point. Demand is surging worldwide across companies, industries, and nations." – Nvidia CEO

For the third quarter in a row, Nvidia delivered a record-shattering level of revenue and profit growth – the company seems to have outdone its impressive performance last quarter and posted the best quarter for a large-cap in modern history... again! Staying true to his eccentric style, the CEO highlighted the expansion in demand for Nvidia's hardware and emphasized the growing interest across various sectors, not just major cloud computing companies.

## What did we learn?

**Stellar Quarterly Results:** Nvidia continued to deliver a brisk pace of revenue growth, with revenue soaring to $22 billion (up 265% from last year), driven largely by the all-important data center business. Given the naturally high-margin nature of the business, this drove net income up to a staggering $12.8 billion, a 491% increase from last year. Moreover, management expressed ongoing optimism, providing a robust forward revenue and profit outlook for the upcoming quarter and the launch of its next-generation B100 products that are expected to propel the hardware gold rush even further.

**Expanding Use Cases:** We are now at the stage where growth needs to diversify away from simply the big enterprises and generative AI start-ups. The early commentary around an expanding pool of demand from the healthcare and government sectors is necessary to maintain Nvidia's stellar fundamentals. The spotlight shines especially bright on the healthcare sector - the potential for breakthroughs in drug discovery and applied medicine is both an unmitigated positive for society and a necessary validation of Nvidia's expanding customer TAM hopes.

In 2023, there was a lot of attention paid to the "Magnificent 7" and how the majority of the investment returns were concentrated in these seven companies. So far, 2024 has shaped up to be even more concentrated. In fact, Nvidia alone represents one-third of the entire MSCI World returns. If this continues, it won't be long before Nvidia claims the title of the "Magnificent One". This is not only a stunning achievement worth celebrating but also an underappreciated and underreported risk to the general euphoria prevalent in most equity and bond markets - it's all on the shoulders of one company.

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# Buckle Up: The Convergence of AI & Momentum

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Today, there's a considerable focus on everything AI-related (you're probably thinking...duh, but please keep reading). Clearly, Nvidia, with a valuation of $2.2 trillion, is the largest component of the AI-driven momentum trade we've observed. However, what may surprise some is the scope of this momentum across sectors beyond tech.

Trickle-Down AI: It all began with Nvidia and the need for GPUs. Then came the networking companies, followed by the technology system integrators and the software beneficiaries. While these are all still fundamentally located within the technology sector, it's worth noting how far reaching the influence of AI has become in other areas of the market. Industrial-focused investors have gravitated towards the liquid cooling leader, Vertiv—an indirect AI story—given the growing need for cooling solutions due to increased heat output from next-generation data centers. Most striking to me is the renewed interest in merchant power companies like Vistra. Historically an often overlooked corner of the utility sector, they are now delivering record-shattering performances, fueled by expectations of large data center development, sparking discussions about potential power shortages and the need for baseload power sources such as nuclear energy. We're just scratching the surface with dozens of other examples.

Momentum & Crowding: In the current market paradigm, and over the short term, the future of the AI trade has become crucial for the direction of the US equity market. The exceptional performance of AI winners and a statistically extreme level of momentum trade crowding, largely focused on AI either directly or indirectly, have been observed in the data. In fact, we're approaching a level of crowding that not only surpasses the past decade of growth factor performance, but is also nearing the peaks of the 1998-2001 Tech, Media, Telecom bubble. With record crowding, we are situated firmly in what's known as the tail of the distribution of return outcomes. This means every price move, up or down, is significantly exaggerated in both directions. That's a lengthy way of saying it's entirely normal and arguably expected to see Nvidia and the rest of the AI basket gapping up and down 10% within a day.

Next Tuesday, Nvidia will be hosting a major developer event with high expectations for the announcement of next-generation chips. No doubt, the next-generation technologies will be even more impressive than the A100 & H100 generation. However, it's essential for investors to appreciate the broader picture. The convergence of extreme trade crowding across a large and diverse cross-section of the market and the optimistic expectations combine to create a uniquely wide range of upside and downside outcomes. Buckle up, next week Nvidia is going to set the tone!

Have a great weekend!

# Day #599... Of Making History

**Dan Rohinton,** Vice-President, Portfolio Manager, Global Dividend

Time flies!

We are just one day away from hitting a brand-new milestone in the financial markets; tomorrow will mark Day #600 of an inverted yield curve. The prior record, set between 1989 – 1990, lasted for 450 days. Historically, a persistent period of yield curve inversions signals that a recession is near, often spooking financial markets.

So, why isn't the economy in a recession yet?

You Only Live Once (YOLO) Mentality: A significant shift in the mindset of consumers has occurred. After the once-in-a-generation shock that was COVID-19, people started reconsidering what truly mattered to them. The "YOLO" mentality has taken firm root. The 'buy now, travel now, worry later' mindset is reflected in macro data. The personal savings rate has hovered around the 4% mark for the third year in a row, a low only once reached back in 2005 – 2007. Over the long term, such a rate is not sustainable. However, undeniably, it has played a prominent role in maintaining economic growth through resilient consumption.

A Two-Tier Consumer: The U.S. has demonstrated a unique durability in its ability to absorb significantly higher interest rates. This is contrary to what is taught in economic textbooks, where higher rates ought to be detrimental. However, it's worth considering the critical role of housing financing in the U.S., which differs from economies like Canada. The average U.S. homeowner usually takes out a 30-year fixed-rate mortgage, in contrast to Canada, where a 5-year fixed mortgage is the norm. If you own a home or any other financial asset, higher interest rates could be a stimulus. It's not uncommon for a homeowner to pay their bank 2% interest on their loan and lend to the U.S. government at 5%. This is a phenomenal deal! Unfortunately, it's only applicable to homeowners and not the many tens of millions of U.S. consumers who must navigate the pitfalls of high inflation and ever-rising borrowing costs. However, the key point of this cycle is that higher interest rates are a problem for only 34% of Americans (66% of Americans own homes), while textbooks predicted a 100% impact on all consumers.

I'll be the first to say that this topic is immensely nuanced and multi-dimensional. Fixed-income investors are juggling several factors: pricing in Fed policy, nominal growth rates, expectations of the neutral rate ("R*"), the term premium, and absorbing economic data. Yet, the core question remains: is the yield curve wrong about signaling a recession? Only time will tell, but it's worth appreciating why economic growth has remained so durable over the past two years. A YOLO spending attitude and inverted financing structures for U.S. consumers are possible over the short-term but arguably unsustainable over the long term. As investors, we see the value in adopting a diversification-first approach during these historical times, prepared to manage whatever comes next.

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# Chococolypse Now: The Unfolding Chocolate Saga

**Dan Rohinton,** Vice-President, Portfolio Manager, Global Dividend

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Most consumers have already heard about "shrinkflation," but I have bad news for all the fellow chocolate lovers out there. We are very likely entering a period of "hyper-shrinkflation" in the coming quarters for an array of chocolate products as the raw material hedges at major consumer companies expire. The main input ingredient, cocoa, has seen a surge in spot prices, skyrocketing over 230% just in 2024 alone. Even the forward Cocoa futures—which look past short-term disruptions—are up 60% in 2024. In no uncertain terms, chocolate will become more expensive.

So, how did we get here?

The Supply Problem: The cocoa value chain has been neglected for several years with underinvestment, poor labor standards, and highly concentrated production zones (i.e., Ghana & Ivory Coast, which produce 60% of the global supply). This year, the crop has been disrupted due to poor weather in these key West African countries, leading to a 500,000-ton shortfall; that's 10% of the 5 million ton annual industry production. As with many other commodities, higher prices lead to greater incentives for production; however, there's an important wrinkle in the cocoa market. New cocoa plants take anywhere from three to five years before they produce any pods for harvesting. It's foreseeable that major chocolate producers such as Mondelez, Hershey, Lindt, and Barry Callebaut will be frantically searching for synthetic alternatives. Nutmeg-infused Kit Kats, anyone?

The Rise of Inelastic Demand: Over the past decade, Chocolate demand has surged, rising almost 30%. We've seen the impact of emerging market economies where consumption growth is on the rise as chocolate becomes an everyday luxury that more consumers can afford. In addition, across developed markets, we observe a shift from milk chocolate to semi-sweet and dark chocolate. This isn't a negligible shift when it comes to cocoa demand. Milk chocolate consists of only 10-20% cocoa, whereas dark chocolates typically contain 70-90% cocoa, making them significantly more crop-intensive.

We are still in the early stages of this story, and there is time for companies to adjust their formulations to minimize sticker shock for consumers. However, there's an essential lesson to be appreciated here. Cocoa is but one of many day-to-day commodities with long lead times before new supply can be turned on and with demand that continues to grow. We can see how exponential price increases can occur in a short period if there are disruptions to supply.

It's worth appreciating that we could be having this exact conversation about other commodities like copper, nickel, wheat, and oil. Supply-side resilience matters. Hopefully, this serves as a lesson for more economically significant commodities.

Have a great Easter weekend!

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## About iA Global Asset Management (iAGAM)

**ROOTED IN HISTORY, INNOVATING FOR THE FUTURE.**

A magnet for top investment talent, iA Global Asset Management is one of Canada's largest asset managers, with over $100 billion under management across institutional and retail mandates. We help investors achieve their long-term wealth creation goals through innovative investment solutions designed for today's complex markets. We are building upon our historic success, supporting the growth of our core strengths, and exploring innovative ways to meet investor needs. We are rooted in history and innovating for the future. Our experienced portfolio managers use a proprietary investment methodology, rooted in iAGAM's unifying commitment to strong risk management, analytical rigor and a disciplined, process-driven approach to asset allocation and security selection.

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