



## INVESTOR INSIGHTS – SECOND QUARTER 2025

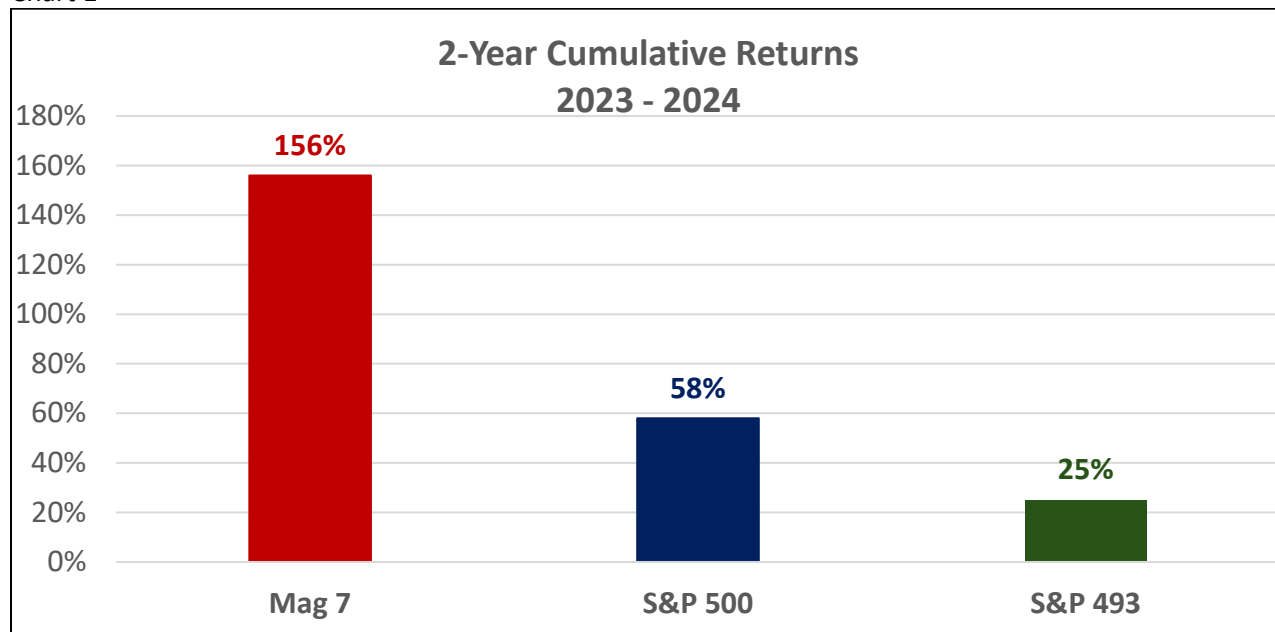
### A Tale of Two Markets, which is it?

In our year-end newsletter, which came out in January of this year, we warned everyone about the overpriced nature of the domestic stock market. As you know, we use price-to-sales data rather than price-to-earnings data for two reasons. The data exists for a longer time frame, over 150 years, and while sales can be manipulated, it is much more difficult to do so than earnings. So, what we believe is we get a much clearer picture of the valuation of the stock market. The question we are always asking for any of the markets we study is: Is this market fairly priced, underpriced or overpriced?

At year-end 2024, the S&P 500 was more highly priced than at any point in history. The price-to-sales ratio of the S&P 500 was over 3. This was the first time the price-to-sales ratio had ever hit 3 times sales. It did not do so in 1929 at the peak of stock prices during the depression, nor did it reach this high at the end of the first quarter of 2000, the peak of the market for the 1982-Q1, 2000 great bull market. We all remember what happened after 1929, and the decade of the 2000s saw the S&P 500 compound at -0.10% for the entire decade. \$100 invested in the S&P 500 at the beginning of 2000 was worth \$90 at the end of the decade. During this decade, our dividend strategy compounded at 8.2%.

In their current quarterly newsletter, Dearborn Partners analyzed data on the various parts of the domestic stock market for 2023 and 2024. They divided returns for the market during this period in the way it has been analyzed by many observers, by showing the returns of the S&P 500 Index, the Roundhill Magnificent Seven ETF, an ETF representing the “Magnificent 7” stocks and the Defiance Large Cap ex-Mag 7 ETF, representing the remaining 493 stocks in the S&P 500 Index. The chart below shows what they found.

Chart 1



Source: Dearborn Partners



So, it is easy to see that the S&P 500 returns were dramatically concentrated as we headed into this year, just like it was as we headed into 2000. We do not have data on the contribution to the total return of an index by a few stocks, but we feel confident in saying that in a 2-year period when 7 stocks contributed more than to the total return of the index of 500 stocks, if not a record, it is close. It is also a warning that it cannot continue.

We always ask ourselves when looking at any investment: Will the clients of RIAs think this strategy makes sense to them? In terms of this data, if you had gone to your clients at the beginning of 2023 and suggested they invest in 7 stocks rather than a diversified portfolio because you thought they would get 3 times the return of the 500 in two years, how many clients would have thought that was good logic? We all know the answer, none of them. What likely would have happened is that you would have had fewer clients.

### **What Does History Tell Us about Periods of Concentration?**

In 1998 and 1999 when we saw 6 stocks contribute most of the return of the index over the previous two years, the S&P 500 saw a negative return for the future decade. So, is that what we expect for the next 10 years? Well, we do not make those types of predictions, but we do have a reliable source that does. Rob Arnott runs a firm called Research Affiliates on the West Coast. They are a large investment manager and a research firm. They publish every day their expectation for the return of 25 asset classes over the next 10 years. Their expectations for the return and volatility of domestic large cap stocks are as follows:

	<u>Domestic Large Cap Stocks</u> <u>Future Return and Volatility</u>
Return	3.3%
Standard Deviation	15.2

Now several observations are necessary when looking at this data. The numbers are calculated by observing history. In other words, when we have seen prices this high as calculated by Research Affiliates, the outcome was as stated. And our second observation is that we do not take these numbers literally because we know that the future will not be identical to the past. So, we view this observation as an indicator of whether future returns will be average, above average or below average. These numbers clearly indicate to us that expected future returns for large cap domestic stocks will be well below average. Like our observation for the returns of the 2000s, we wonder if index investments will solve the investment returns needs of any investors. Our guess is it will not, just as it did not in the decade of the 2000s.

So, let's look at other asset classes. As you know, our equity strategy is made up of dividend portfolios in the domestic large cap, domestic small cap in international arenas. These are the Evaluation Associates expected returns and standard deviations of international and domestic small cap.

	<u>International Equity</u>	<u>Domestic Small Cap</u>
Return	8.1%	7.8%
Standard Deviation	16.2	20.3



Now we would not expect these numbers to be exact, but we do expect that International and Domestic Small Cap will far outpace Domestic Large Cap. We do not think any analyst can review that data and disagree with this conclusion.

### **What Does History Tell Us about Returns Based on the Valuation of the Stock Market?**

This table shows the Price-to-Sales Ratio of the domestic stock market over the last 150 years.

<u>Price to Sales Ratio</u>	<u>Number of Months</u>	<u>Percent of Total Months</u>
Above 3.0	12	1%
2.99 to 2.5	37	2%
2.49 to 2.0	118	6%
Under 2.00	1,687	91%

So, what does this tell us? It tells us two things. The first is that a valuation of over 2.5 times sales is very unusual. It has occurred in less than 3% of the month ending valuation over the last 150 years. That is 2.5 times sales not the current price-to-sales of over 3.0. The math is interesting, the market could fall from here over 3.0 times to 2.5 times, a 16.7% decline and still have a valuation in the top 3% of history. The second observation is that we have a long way to go in order to get to normal, where we might expect a 10% annualized rate of return over the next decade.

No one can give us any insight into whether this might happen quickly or take a long time, we have examples of both in history. What we do know is that future investing in the S&P 500 will be painful. If you use indexation, our warning to you is to take your gains and run. Our dividend strategy is a great replacement which will produce attractive returns over the next decade when the S&P 500 will not. Will it be identical to what happened in the decade of the 2000s? Likely not, but the experience is very likely to feel the same.

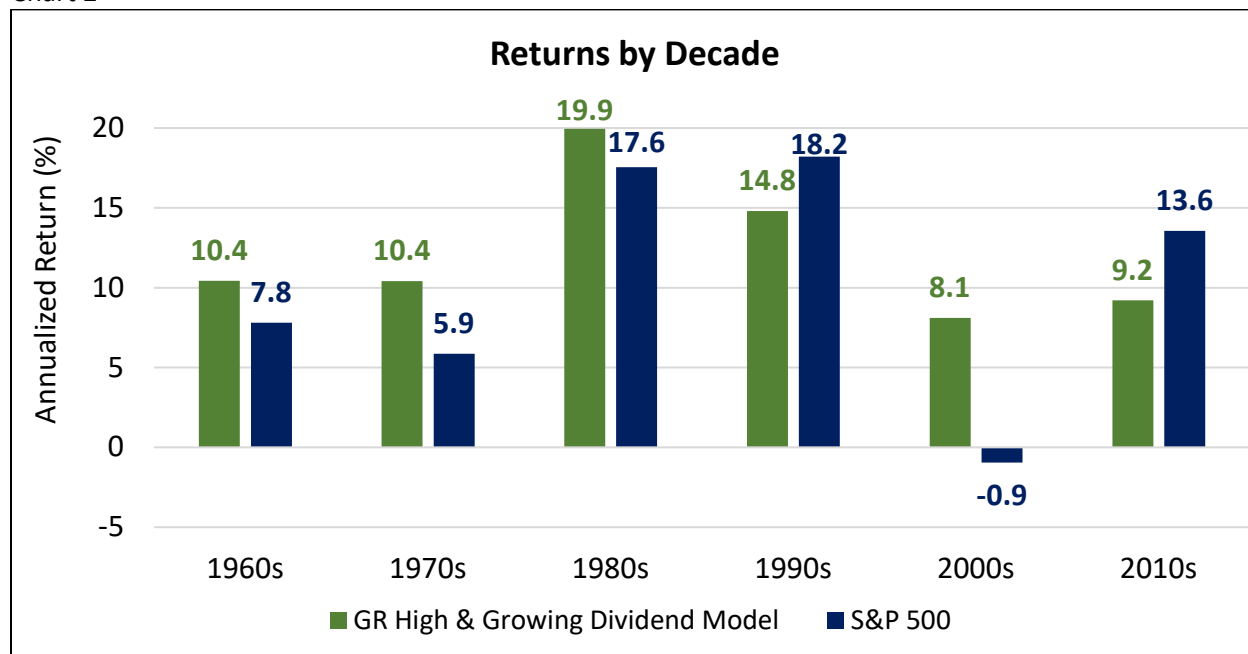
### **Dividend Strategies Compared to Index Investment Returns**

We have written about this extensively over the past, but it is important to review this in light of the current concentrated nature of the domestic large cap stock market as well as the high valuation of this market.

The chart below shows the returns of the S&P 500 and our proxy for our Domestic Dividend Strategy. Since 2000, we have used the portfolios we manage in the Domestic Large Cap Growing Dividend space and prior to 2000, we used the analysis Jeremy Siegel did for Wisdom Tree in the development of their ETF Dividend Strategy. The chart shows the full calendar decades since the S&P 500 was started in 1957. It is worth noting that dividend strategies outperformed the 1957-1959 period and have underperformed the 2020-2024 period. Both of these periods we would find predictable. The first period was an era of reasonably priced stocks when dividend strategies should have outperformed, and the 2000-2024 concentrated returns are not a period when we would expect dividends to outperform.



Chart 2



Source: Morningstar Direct

So, this data is clear, a growing dividend portfolio has and will continue to outperform index investing. The issues supporting the case for indexation are weak at best when you look at the whole picture. In only 3 of the 6 calendar decades did you achieve a 10% return by investing in indexation. Now we would say that the 7.8% return in the decade of the 1960s comes close and solves the investment return needs of most clients. That said, the decades of the 1970s and the 2000s do not come close. Indexation got you into a deficit that took long periods to get out of.

The dividend strategy offered a much different picture. Dividend investing got you a 10% return in 4 of the 6 decades and in the two decades where they were short of 10%, the returns were 9.2% and 8.1%.

So, this is very compelling. The stock market is dramatically overpriced, and we have a domestic equity strategy that will perform well and solve the investment needs of your clients even if the index does not. This tells us we have the right strategy for now, and we worry about those who conclude otherwise.

### Our Total Equity Strategy

Our recommended equity strategy allocates 42.5% to domestic large cap, 42.5% to international and 15% to domestic small cap. Our expectation for future returns is that all three components will achieve attractive returns over the next decade. We think those returns will be close to or slightly above a 10% per year return. So, we are comfortable with where we are in terms of recommendations in the equity arena today.



## **Other Asset classes**

We have not owned fixed income for 6 years and see no reason to own it today. The legislation just passed by Congress and signed by the President is inflationary. We will see what the Fed does with rates, but we doubt rate cuts will come any time soon.

Our substitutes for fixed income are the 3EDGE Conservative and 3EDGE Total Return portfolios. They have both performed well relative to bonds and we think they will continue to do so. The best example of this was in 2022 when the 10 Year US Treasury fell by 13%, the Conservative portfolio fell by only 4%.

## **Bitcoin**

We started talking to clients about adding a small portion of Bitcoin to the appropriate client portfolios about 5 years ago. Today Bitcoin is up ten times the value of 5 years ago. Many of you have initiated putting clients' Bitcoin on a separate balance sheet since it has become such a large position. Our view is that 5 years from now, Bitcoin will have another rise similar to the rise of the last 5 years. Our expectation is a Bitcoin will sell for around \$1 million a coin 5 years from now.

Now a caution, Bitcoin is remarkably volatile. When we recommended Bitcoin 5 years ago, it went from \$10,000 a coin to \$70,000 a coin and then fell to \$20,000 a coin. We will have no ability to help you pick interim tops and bottoms along the way. We also believe that while the volatility of Bitcoin may drop some, one should expect remarkable volatility along the way. The only clients who should own Bitcoin are those who can sleep well with this type of volatility.

## **Private Investments**

Clients used private investments over the past 15 years with remarkable success. The best example was investment in a firm called Landmark. These were 3 year holding private investment that achieved returns of 14%, 15%, 16%. We did have one fund that got extended to 4 years, and our expectation is that with our current lineup, that could happen again. We are excited about these private investments because we think they will achieve returns similar to those we achieved with Landmark.

## **Difficult Times**

These are clearly challenging times in the investment world. We would welcome the opportunity to help you discuss our cumulative investment reality with your clients in any way that might be helpful.



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