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INVESTOR INSIGHTS – FOURTH QUARTER 2023

When 1998 came to a close, we had the suspicion that very few stocks had accounted for the total return of the S&P 500 which achieved a 28.57% gain. What we found surprised us, the top 11 stocks accounted for more than the total gain for the year. What this meant was that the S&P 489, the bottom 489, was down for the year. The following year was even more dramatic and odd, the top 6 stocks accounted for more than the total return of the index which was up 21%. The S&P 500 index was up 55% for these two years but the concentration came from a very small number of stocks. This year is a repeat of those concentrated returns of 24 and 25 years ago. For the first 9 months, 7 stocks account for a total contribution of 85% of the return of the index and are up as weighted in the index 11%. The index return without these stocks is up just 2%. Just like in 1998 and 1999, the stocks leading the index today are great companies, the problem is finding great companies is not enough to have a great investment thesis. In order to have a great investment thesis, you need to have a method to buy these great companies at reasonable prices.

Rob Arnott runs an investment firm called Research Affiliates. He published every day on his website their expected returns for various asset classes over the next 10 years. At the end of Q3, he showed an expected return for Large Cap Domestic Equities 10 years from now of 4.1% and for the Aggregate Bond Index of 4.5%. While we do not have the data from 1998 and 1999, it was assuredly projecting very low returns. The methodology Research Affiliates uses is very thoughtful and very simple, if stocks are trading at low P/Es their projected future returns are high. While if stocks are trading at historically high P/Es, their projected future returns are very low. We have discussed this in several of our last newsletters: stock prices are very highly priced today by historical standards. We prefer price to sales ratios over price to earnings ratios because businesses cannot manipulate their price to sales ratio as easily as they can their price to earnings ratio. Today the price-to-sales of large cap domestic equities is in the top 5% of price to sales ratios going back 120 years. You may recall in our last newsletter, we took out the lower half of price to sales ratios over this 120 years and still found the current price to sales ratio is in the top 5%.

So, concentration of return and high price to sales ratios are a warning signal. They are telling us the expected future return of the S&P 500 will be subpar. Will they be 4.1% over the next 10 years? Likely the answer is no, precision on future returns is an inexact science at best. This is what we can say with certainty, investing in the S&P 500 over the next decade will not solve the investment return needs of many, if any, of your clients.

The biggest winner in this crazy rise this year is Nvidia, up 435% over the first 9 months. To say the stock is overpriced would be a gross understatement. Ark, known for holding very high-priced stocks, sold Nvidia this year at $185. They sold it because they could not see how Nvidia would achieve a 15% compounded annualized return over the next 5 years with the stock selling at $185. They have been ridiculed for this sale, a stock they first bought at $5 a share over 7 years ago. Anywhere you look for data on the current price of Nvidia, you will find reports of the valuation being ridiculously overpriced. Great company? Yes. Great investment at these prices? Very unlikely.

By contrast with these examples of crazy price levels, our domestic dividend portfolios have a current yield of 3.74% with expected dividend growth of 7% or more. Do we wish it had a yield of 5%, sure, but it

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is still reasonably priced? If we start with a 3.74% yield and grow dividends at 7%, the yield 10 years from now will be over 7.35%. If that is even close to what we experience, we do not believe the dividend yield will be over 7.35%. What we think will happen is the price will rise significantly raising the price of the underlying portfolio and providing a double-digit total return for investors.

We are just as optimistic about the future returns from our international portfolio. The current yield of that portfolio is 3.72%. Our expectation is that dividend growth will also be 7% or thereabouts. Total return will be similar to our expectation of total return on the domestic portfolio.

So, today we see a bright future with our portfolios and a bleak future for the indexation folks. They may be shining brightly today but history tells us their future is bleak.

Liquidity

Everyone loves liquidity, we love liquidity! We would welcome the opportunity to invest in just liquid ideas and portfolios. Over the years, however, we have found great investment opportunities that were not liquid. Landmark was one of those investment opportunities. Landmark developed non-liquid investment portfolios that had a 6% current yield and total returns of approximately 15% with a three-year maturity. Now one of their funds did extend duration in 2008 because of the decline in stock prices and the lack of buyers. That fund did return principal and interest the following year in 2009. Today, there are two Landmark funds that have extended maturity. So, we point this out as a warning on maturity being a precise dimension of illiquid investments.

Today we have two investment opportunities that resemble Landmark in very interesting ways. First, they both have a current income of 6%. They both also have reasonable maturities, 4 years, 1 year longer than Landmark. They both have expected returns in the 15% area. We actually think both of them will be higher than 15%, but that remains to be seen. They both are available to accredited investors, and they both have very low minimums of $50,000. We can also get exceptions for clients who want to invest less on a case-by-case basis.

The first is a loan portfolio run by Red Oak. The loans are up to 2-year maturities but generally shorter. The reason firms looking to borrow use them is they can get an approval on a loan in 30 days. Given the rise in rates, two good things have happened. First, banks are even slower to make decisions, it was 6-9 months but now longer. Second, the rates Red Oak can charge are higher. The reason the investment is 4 years is Red Oak wants to turn the loan portfolio twice. They are projecting, and currently getting, IRRs higher than 15%.

The second portfolio is an apartment portfolio run by Carter Funds. They buy 20-30 year old apartment complexes with a few hundred units that have not been updated. They do two things to turn the investment around. First, they redo the public areas, pool, landscaping, driveways, etc. They also update 25% of the units with new bathrooms and a new kitchen. This allows them to rent a completely redone apartment, one with just a new kitchen or a new bathroom, or one not refurbished. The return on refurbishing units is upwards of 40%. They manage the portfolio for two years after refurbishing the units. When a new lease comes due to an existing tenant who wants to stay, they can redo the bathrooms and kitchen in one week if the tenant wants an upgrade. Two years after the refurbishing, they put the complex up for sale. The multiple at sale will increase from the multiple at purchase

because of the improvements. The appeal to the buyer is they can complete the refurbishing and increase their cash flow. The IRRs should be 15% or higher to the limited partners.

We also have a 2-year maturity illiquid investment with 8% current cash flow. This investment will not provide return beyond the cash flow. We have information available on all three of these investments and would be happy to send it to you and discuss the opportunities with you.

So, why are we encouraging illiquid investments today, especially when we just expressed a very optimistic view of great returns from our dividend portfolios? There are two reasons. First, diversification is a key component in portfolio development. We think we need to provide you with several ideas that can solve the long-term investment return needs of your clients, and both of these investments accomplish that. Second, we live in a cash flow starved world, and 6% cash flow with safety is very hard to find. As you know we have not recommended fixed income as a component of portfolio construction for years. We believe even today, fixed income is not an attractive asset class. Fixed income had two components in portfolio construction historically, low volatility and high cash flow. Today, one can still get reasonable cash flow investing in fixed income, but fixed income has had very low returns because rates have risen. The low volatility component of fixed income was blown apart last year when the 10 Year US Treasury declined by 16.3%. Low volatility does not mean double digit losses in anyone's definition. Will we see double digit losses in fixed income in the future? That is anyone's guess, but what we do know is that there is pressure on rates to rise. If that pressure on rates to rise turns out to be our reality, returns in fixed income will continue to be subpar. Someday we will be constructive in fixed income again, just not now.

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