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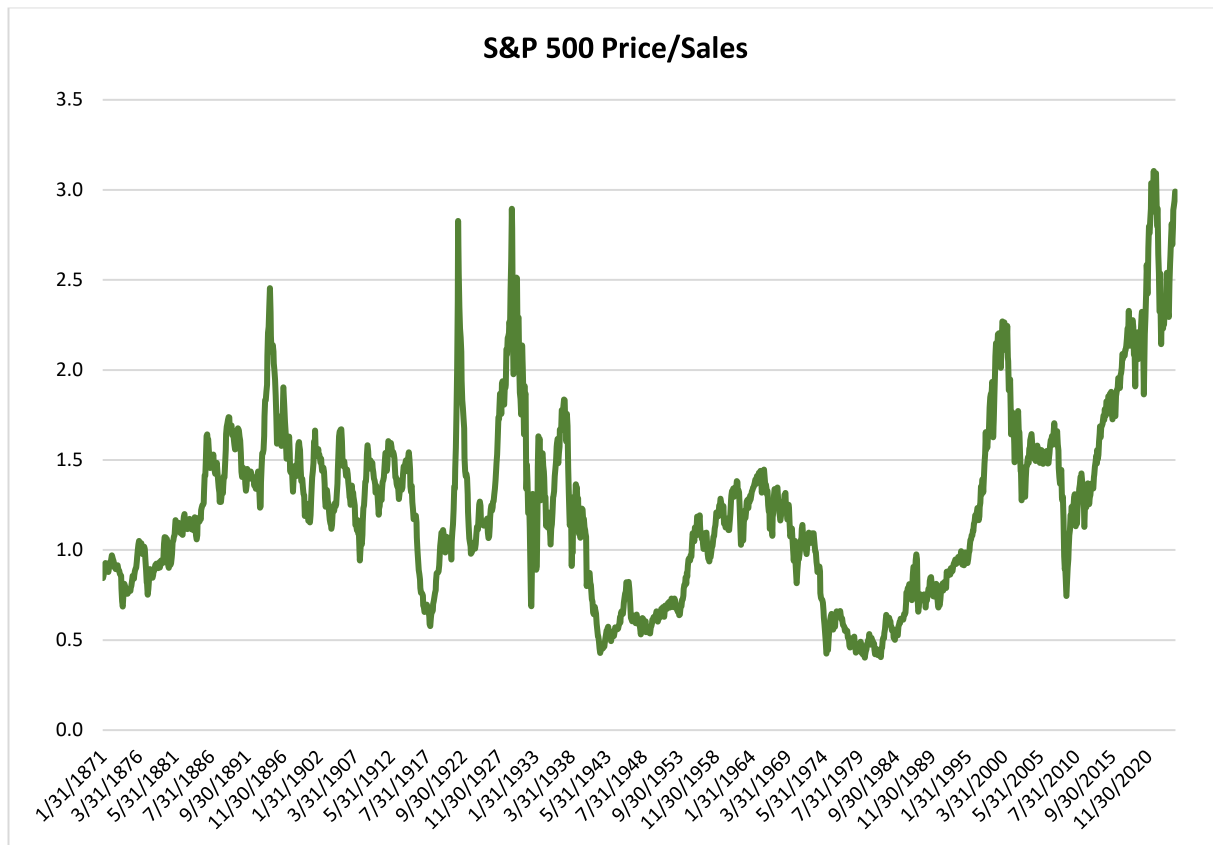
INVESTOR INSIGHTS – THIRD QUARTER 2024

Current Valuations Suggest Caution

The history of valuation teaches us to be cautious when valuation levels reach certain thresholds. Today, the domestic stock market, as measured by the price-to-sales ratio of the S&P 500 Index, suggests that we should be very concerned.

The chart below shows the price-to-sales ratio of large cap domestic stocks going back to 1871. This data was provided to us by 3EDGE, and we appreciate their work on this topic. As you may know, the S&P 500 index started in 1957, and the data prior to that is based on returns of large cap domestic stocks. Today, we find ourselves in that stratospheric range we have rarely seen. This is the fifth time the price-to-sales ratio has been over two times, and today it is slightly over three times. Historically, every time this happened, the future was not a great time to be an index-based investor or a growth stock investor. Does that mean the stock market index will fall dramatically from here? Well, that is the question for which no one has an answer, but history would warn us to be very careful. Our view is that it is not a question of whether our domestic stock market will fall, but rather when it will fall.



Based on S&P 500 sales data beginning 1/31/1990; Based on industrial sales 1/31/1965 through 12/31/1989; Prior to 12/31/1964 estimate based on nominal GDP data.
Sources: Bloomberg, Economist, Internal.

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We have written recently about the concentration of a few stocks driving returns earlier this year. We chose the top seven stocks, although you could expand that list to the top ten. As you may recall, for the first six months of this year, the S&P 7 was up 32.8% while the S&P 493 was up 8.5% and our domestic dividend strategy was up 6.3%. Concentration was a fantastic idea for the first six months of this year, but our question is, have we seen the end of that phenomenon?

Much has been written historically about concentration at the peak of long bull market runs. When we did the attribution of the S&P 500 in 1998, we found that the top 11 stocks accounted for the entire return of the index. That was followed by even greater concentration in 1999 when the top six stocks not only provided the entire return of the index but the entire return of both years, 1998 and 1999. Following 1999, those six great stocks fell. The shortest time it took for any of those seven stocks to get to full recovery was just under ten years.

Now it is worth reviewing what happened long-term to the leaders of the stock market after 1999. Yes, those stocks declined, and it took a decade for all but one to come back to even. That said, if you had bought the leaders of that time on January 1, 2000 and held them through today, you would have achieved above average returns. We point this out because AI is and will be a very powerful development in our world. It will impact our lives and the lives of our companies in powerful ways. Our issue with these companies is not about their future, it is about their current valuations, they are simply too high and too optimistic.

Third Quarter Shift

In the third quarter of this year, the emphasis shifted from great returns coming from a few high-priced stocks to great returns coming from the average stocks and from growing dividend strategies. For the third quarter, the S&P Index was up 5.9% while the equally weighted index was up 9.6%. So, the breadth of the market outperformed the stocks that had been leading the average stock. Our large cap domestic dividend manager achieved a return of 12.1%.

So, that is a pretty dramatic shift, but it is only one quarter. So, does one quarter make a market? We would suggest it definitely does not make a market, but we would not be writing about this change if there were no other issues that concern us.

Market peaks never come with an announcement, they just happen and do so to most investors' surprise. You may recall that the market peak starting in April of 2000 saw returns for 2000 down -9.1%; 2001 down -11.9% and 2002 down -22.1%. I recall giving a speech on the financial press in 2004, and my premise was that the press starts with a premise of bullishness or bearishness based on the most recent returns of the market. If you reviewed the financial press tone of 2000, 2001 and 2002, you would find that the press was writing bullish articles in 2000. They then got a little bearish in 2001 and were very bearish in 2002. So, if you took those articles as investment advice, they were saying not to worry in 2000, maybe worry a little in 2001 and worry a lot in 2002 after you were down significantly. We would expect most clients to fire their financial advisor for providing this type of analysis.

So, we would urge caution today with what you get from the financial press. They are saying there is no reason to be cautious; the Fed just lowered rates and this grand, concentrated bull market will continue. We might even get a second and third rate cut this year. Our view is that while we very well

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might get two rate cuts, large cap domestic stocks as measured by the S&P 500 are ridiculously overpriced, and that is never a great time to invest.

Will the Fed get it Right?

There is another issue on which we would urge caution. The history of the Fed getting their rate adjustments correct is not good. Certainly, there are exceptions. Paul Volker got the raising of rates correct when he was trying to bring down inflation in the 1970s and 1980s. When he took over at Fed Chair the Fed Funds rate was 11%. The Fed raised rates several times in the next 20 months until the Fed Funds was 20% in June of 1981.

The only other time the Fed got rate cuts right was 1995. In that year, the Fed lowered rates perfectly, calming inflation and allowing the S&P 500 to rise until it peaked in March of 2000.

So, our question today is with the price-to-sales ratio at or close to an all-time high. What do we expect? Well, the short answer is we do not expect above average returns. When stocks are cheap, you can expect great future returns. But when stock prices are expensive as they are today, future returns are awful. It is always true that taking a long-term approach will reward investors. When stocks are expensive like they are today, index investing will be very frustrating.

Projected Returns

The data we use for projected returns from various asset classes comes to us from Research Affiliates. They provide projected returns from 23 asset classes ten years out. Now, we do not take their projections to be an exact calculation of future returns. We use their projections to look at comparisons between various asset classes. Today, their projected return for large cap domestic stocks ten years out is 3.2%, for domestic small cap stocks is 7.4% and for developed countries non-U.S. is 9.5%. What this is telling us is that the index for large cap domestic stocks is overvalued while the index for domestic small cap stocks is fairly valued and for international stocks is undervalued. What this also tells us is that index investing in domestic securities will not produce returns that will solve the investment needs of clients over the next decade.

We saw this play out just a little over 20 years ago. When the domestic stock market peaked in March of 2000, it was the start of a decade that actually saw negative returns for the decade. The decade of the 2000s saw the S&P 500 achieve a return of -0.95% per year. $1,000,000 invested at the beginning of the decade in the S&P 500 was worth $900,000 at the end of the decade even with the additions that came from dividends. The first nine years of that decade saw even worse returns, the index was up over 26% in 2009.

So, history suggests real caution when stock prices are as high as they are now. You could not have found an analyst in March of 2000 as the S&P 500 peaked who suggested negative returns for the remainder of the decade. The phenomenon of the prejudice of the financial press that we saw in 2000, 2001 and 2002 is alive and well today. We will get more rate cuts, higher stock prices and everyone will be happy! Do not believe it! Use historical data as your guide and be patient if you are early.

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Projected Returns:

Large Cap Domestic	3.2%
Small Cap Domestic	7.5%
International	9.3%

Our question is if these relationships turn out to be close to correct, and knowing the history of poor returns for extended periods from indexation, why would you index? As you know, we have never indexed, so our answer is obvious.

Now, a legitimate question is: why will growing dividend stocks do well if we are right about what we see ahead? There are two parts to the answer to this question. The first is the phenomenon of growing cash flow. Today, the Growing Dividend Portfolio has a current yield of 3.5%. If we assume growth of dividends of 8%, the portfolio's cash flow will grow by 70%. Now, we will need to adjust that portfolio cash flow for market value ten years from now, and we have no idea what that might be. That said, it is hard to believe it will be at a lower valuation than it is today. The final yield on the portfolio will be 7.6% using these assumptions. It is hard to imagine a growing dividend portfolio having a 7.6% current yield.

We think the yield will be lower and there will be appreciation. In addition, we think the domestic portfolio returns will be a multiple of the domestic index return. In the decade of the 2000s when the return of the S&P 500 was negative 0.95%, our dividend strategy grew to 7.7% per year. So, we achieved an excess return over the index of 8.7% per year for the decade. Is this what we expect for the next decade? Another unanswerable question, but we do expect returns over the next decade that will solve the investment return needs of your clients, and index investing will not.

Our Recommendations

Given all of this, it will come as no surprise that we are very excited about future returns from our dividend portfolios. Every client should consider using this strategy as their core equity investment approach.

3EDGE Conservative and Total Return strategies should be viewed as the substitutes for traditional fixed income in clients' portfolios. The yield on the 10-Year today is 3.7%. That yield will not solve the investment return needs of any of your clients, so we would recommend no fixed income in client portfolios. As of the end of the quarter, the 3EDGE Conservative account is up 6.6% for the year, and Total Return is up 8.9%.

Bitcoin should be a very small part of clients' portfolios whose time horizons are long. ARK has a Bitcoin ETF with a 0.20% expense ratio, and that is the fund we use. We are starting a cycle that historically has seen Bitcoin rise, so we will see what the next four or five quarters bring us, but we would expect significantly a higher price for Bitcoin one year from today.

We have four private investment portfolios with current yields of 6% to 7.7% with maturity. Many of you have been using them, and we would encourage everyone to do so. All of our private funds should be liquidated within four years, and our expected IRRs are in the middle teens.

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The Future

We have been in these times before when we had very few attractive investment options. If we are right and we are at or close to a domestic stock market top, the declines that follow will be uneven and provide us with unique investment opportunities. They always do, so patience and taking a long-term view are the traits we need to stress today.

Disclosures

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