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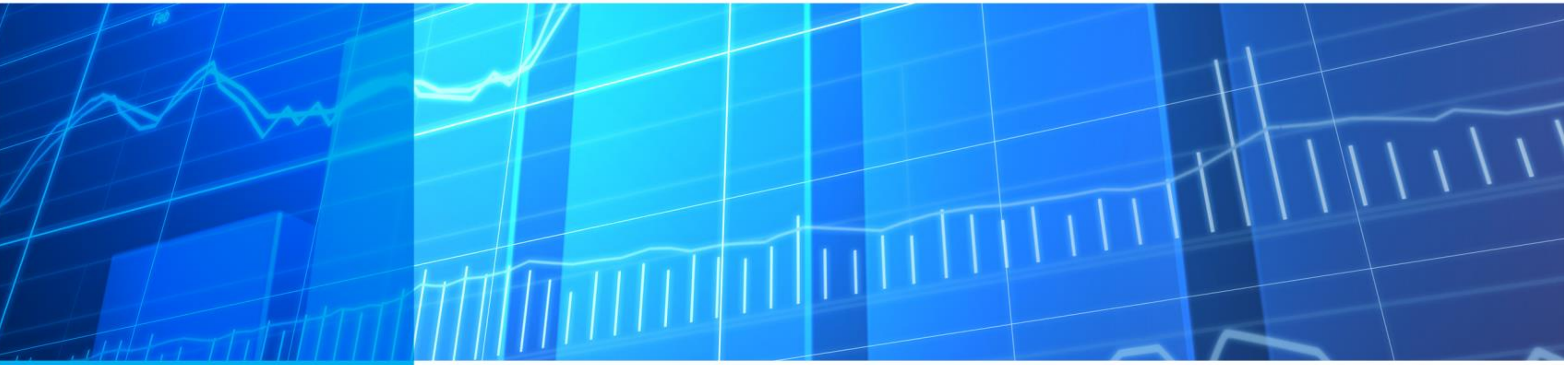

QUARTERLY REPORT

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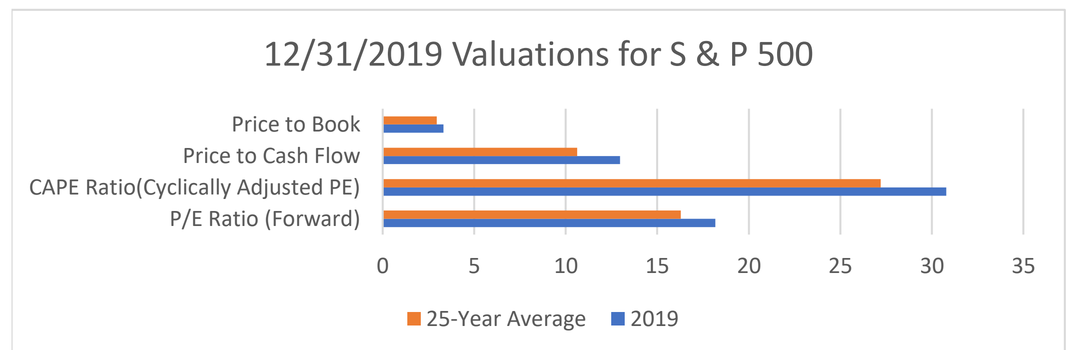
A Curious Time Indeed

As we enter the new decade, I am trying to reconcile a tremendous amount of divergent data. I have found that there is always a healthy amount of optimism or pessimism in any published outlook, as we all have our own biases. However, I do think 2020 is beginning with an unusual pattern of conflicting trends. I don't simply mean in the stock market or economy either. The upcoming election could easily be one of the most unique and unpredictable of the modern era. The situation in Europe has been nearly as theatrical as our own, and perhaps more so at times with Brexit. The environment in Asia might be less chaotic, but you still have uncertainty in Japan, India, China, Hong Kong, and the fires in Australia. I think we can safely attest that we are living in interesting times. With that backdrop, I wanted to share my views on some of the questions that we are hearing most frequently from our clients. I then added quotes from some of the most notable investors in history. My reasoning for pairing these elements is that I have found you need both facts and a healthy perspective to make good decisions during difficult or confusing times.

Are stocks expensive today?

I tend to answer this question from two different perspectives. There are those, like Robert Shiller at Yale, who tend to value stocks based on the historical range for price to earnings ratios. There are others, like Alan Greenspan, who have spoken at length about the key metric for stock market valuation is the price relative to current interest rates. Depending on which of these gauges you prefer, you'll find a different answer to the original question.

Let's start with the historical argument. Here are some of the most common valuation metrics for the S & P 500 index as it ended 2019 and then compared to its own 25-year averages. The short answer is the current valuations are all slightly above average.



Source: J.P. Morgan Asset Management, FactSet Data, Standard & Poors, Robert Shiller

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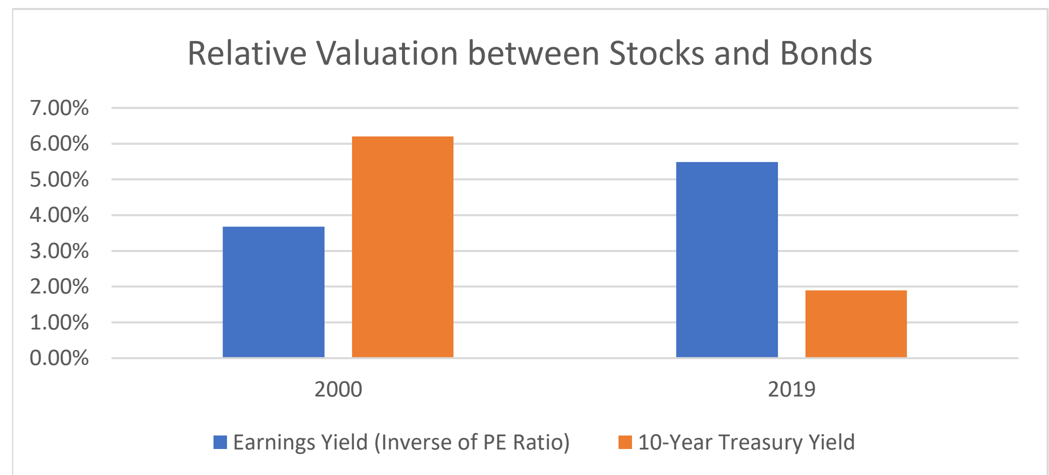
> *"Beware the investment activity that produces applause; the great moves are usually greeted by yawns."*
>
> *~ Warren Buffett*

If you prefer to compare investment alternatives, you will like the next graph. I compared the earnings yield of the stock market to the current 10-year US Treasury yield. The earnings yield of the stock market is not the same as the dividend yield. Instead, it is simply a metric of the aggregate earnings of the companies divided by the market value of the companies for the entire S & P 500 index. I like to use earnings yields or free cash flow yields when I consider a new investment, because it allows me to easily compare that investment to a more traditional income investment without excluding earnings reinvested in the company.

In the next chart, I compared the top of the tech bubble in March of 2000 to the values at the end of last year. Now in retrospect, most of us would agree that stocks were very expensive compared to bonds back in 2000. At least using this metric, you could make an argument that bonds look very expensive relative to stocks today. That doesn't mean stocks are cheap though. The math may simply be telling us that bonds are abnormally expensive.



Source: J.P. Morgan Asset Management, FactSet Data

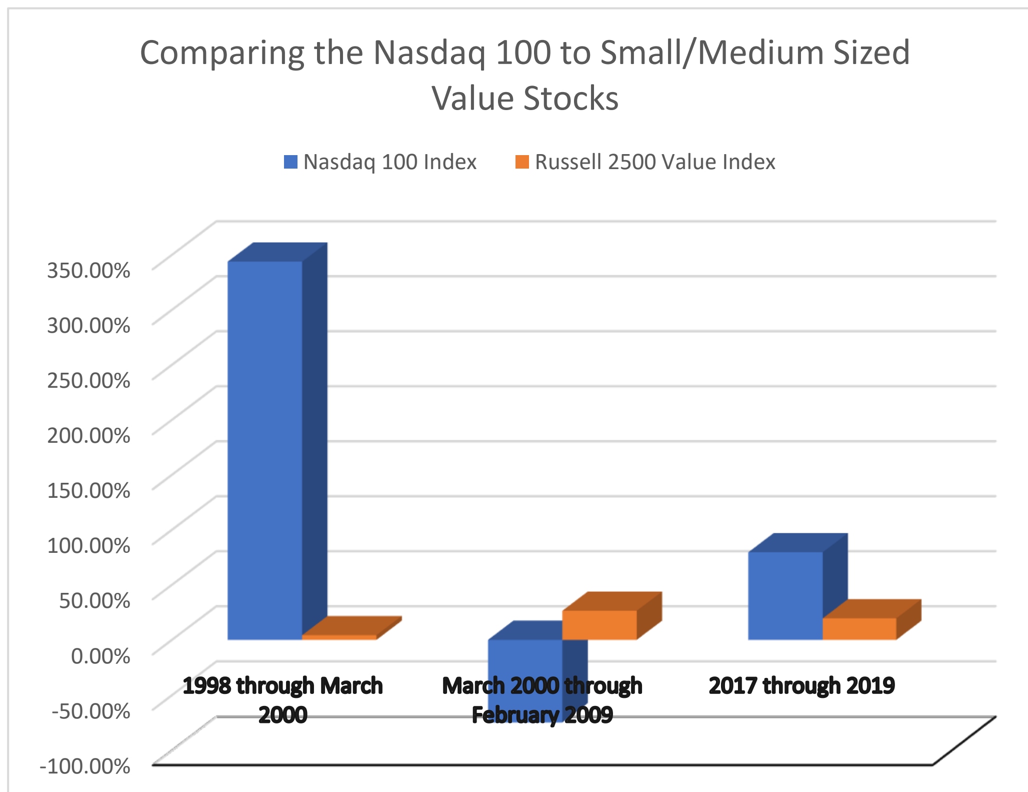
Is this another Tech Bubble?

Unfortunately, we won't know until it's too late. I have spent some time comparing the participation of different market segments though, in case there is a warning sign hiding somewhere in those data sets. If you look again at the prior chart, you'll see that the earnings yield on the stock was under 4% in March of 2000. Over the next decade, the index didn't even return that much. If you had invested $100,000 in the index at the end of March 2000, you would have only had $93,650 ten years later. So, I do see validity in asking if we are in another tech bubble considering the past decade for companies like Apple, Amazon, Facebook, and Google.

As a way to compare the giant growth companies versus the average mid-sized American business, I ran a comparison of the Nasdaq 100 Index (the 100 largest companies in the Nasdaq Composite) against the Russell 2500 Value Index (a group of value-oriented business from the 2500 smallest companies from the Russell 3000). The Nasdaq 100 isn't purely technology stocks, but the index is very highly correlated to the largest tech stocks.

The Russell 2500 Value Index is built of small and midcap stocks with a value orientation, which generally includes companies from slower growing and more traditional industries. I think these indices are a great way to visualize the difference between how the market has treated businesses from the new economy and the old economy in different time periods.

Below, you can see the tech bubble forming between the end of 1997 and the spring of 2000. The second column shows the nine-year window from the 1st quarter of 2000 through February of 2009, which roughly lines up with the Nasdaq peak in 2000 to the market bottom in early March of 2009. While the chart shows the magnitude of those moves, I think it would be even more dramatic if it showed the growth and decline in dollar terms. If you could have invested a dollar into the Nasdaq 100 at the end of 1997, it would have multiplied to almost $4.50 by the spring of 2000, but then would have fallen all the way back to a dollar by the spring of 2009. As you can see from the final column below, the Nasdaq 100 has steadily outperformed again over the past three years, but the magnitude is very different than the one from the late nineties. However, I do think it would be unwise to assume the concentrated outperformance of those largest companies will simply continue without risk.



Source:Thompson-Reuters, Nasdaq, Frank Russell Company

"The investor of today does not profit from yesterday's growth."

~ Warren Buffett

What about inflation? What the national debt?

This is an interesting topic. Generally, a rational person would assume that there is little risk of inflation with global interest rates being near zero, or even below zero for much of the developed world. Typically interest rates look like this only during times of extreme uncertainty or when people are fearful of deflation (like that seen during the Great Depression). However, that surely doesn't seem to fit our current conditions. According to the St. Louis Federal Reserve, 3-month T-Bill yields stayed between 0% and 1% from 1933 until 1947. They fell back under 1% twice during the 1950's as well. The costs of fighting World War II had pushed our national debt to an unprecedented level that greatly exceeded the size of the American economy (as measured by GDP), so it was somewhat irrational that interest rates stayed so low in the face of greater outstanding debt. When I have questioned economists about this period, the usual answer is that people didn't trust the stock market after the Crash of 1929. I believe that isn't unlike today. People always ask me about the next 2008. However, I think investors today should be more concerned about the future returns on bonds as opposed to the volatility of the stock market if that past era when global interest rates were also very low provides us any insight to the future.

Annualized Real Return (after inflation)

Asset Class	1940's	1950's	1960's	1970's
US Bonds	-2.5%	-1.8%	+0.2%	-1.2%
Canadian Bonds	-1.0%	-0.9%	+1.0%	-0.7%
Swiss Bonds	-0.4%	+1.5%	-0.3%	+0.8%
Australian Bonds	-0.2%	-3.1%	+1.7%	-2.9%
British Bonds	+0.5%	-0.7%	+1.3%	-3.2%
US Stocks	+3.4%	+16.7%	+5.1%	-1.5%

Source: Deutsche-Bank Study of Long Term Returns, 2016

"The investor who says, this time is different, when in fact it's virtually a repeat of an earlier situation, has uttered among the four most costly words in the annals of investing."

~ Sir John Templeton

What do we do now?

If you have heard me speak in the past, you know that I don't believe in forecasts. I do believe in owning businesses that we both like and understand. I also believe that we should focus foremost on the quality of what we own, but that we also must pay attention to the price that we pay for that quality. If we are diligent about answering both of those questions, then we should be able to ignore a lot of the emotional headlines that will distract others into abandoning their investment plans prematurely. This is why we focus on owning a targeted portfolio of individual companies with strong competitive advantages. It is my belief that those businesses have the ability to reward their shareholders even during difficult or uncertain markets.

"Buy a stock the way you would buy a house. Understand and like it such that you'd be content to own it in the absence of any market."

~ Warren Buffett

The **Absher Wealth Management Group** is a team of experienced professionals who have a shared belief that professional development is critically important to their client's success. The members of the team hold many advanced industry designations and continue to work on additional professional designations. We believe prudently managed wealth serves as a means to get you where you want to go, and we're committed to delivering our best advice to help you get there.

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