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WEALTH MANAGEMENT

December 2023 Market Commentary

November Rain



*Nothin' lasts forever
And we both know hearts can change
And it's hard to hold a candle
In the cold November rain*

“November Rain” by Guns N’ Roses - <https://www.youtube.com/watch?v=8SbUC-UaAxE>

Nothin’ lasts forever, not even November’s impressive rally, which saw the S&P 500 surge 9.13%, taking our year-to-date S&P 500 total return to 20.68%. I’m not saying that our current bull market is over now, just saying that it, like everything, will one day end.

GNR fans are very familiar with the power ballad “November Rain”, which tells the classic rock story of love and loss. If you haven’t watched the most watched YouTube rock video of all time, I highly recommend cranking your volume up and clicking on the above link. In it Axl Rose sings about love and loss, and the risk we all take when needing somebody.

Love and risk are arbitrary concepts until you experience them. Life is all about taking chances, risk and reward. As investors we must constantly weigh an investments potential reward with its inherent level of risk, understanding that the two go hand-in-hand.

Other than an impressive rally in stocks, this November also saw a successful launch of the SpaceX rocket Starship. Since SpaceX is a private company, it doesn't get as much attention as its sibling, Tesla. But what the company has achieved in 21 short years is simply incredible.

Both SpaceX and Tesla were founded in 2002 and 2003 respectively, by Elon Musk, with the proceeds of his sale of PayPal. Musk often jokes about how "idiotic" it was to start two companies where the odds of success for either were probably less than 10%.

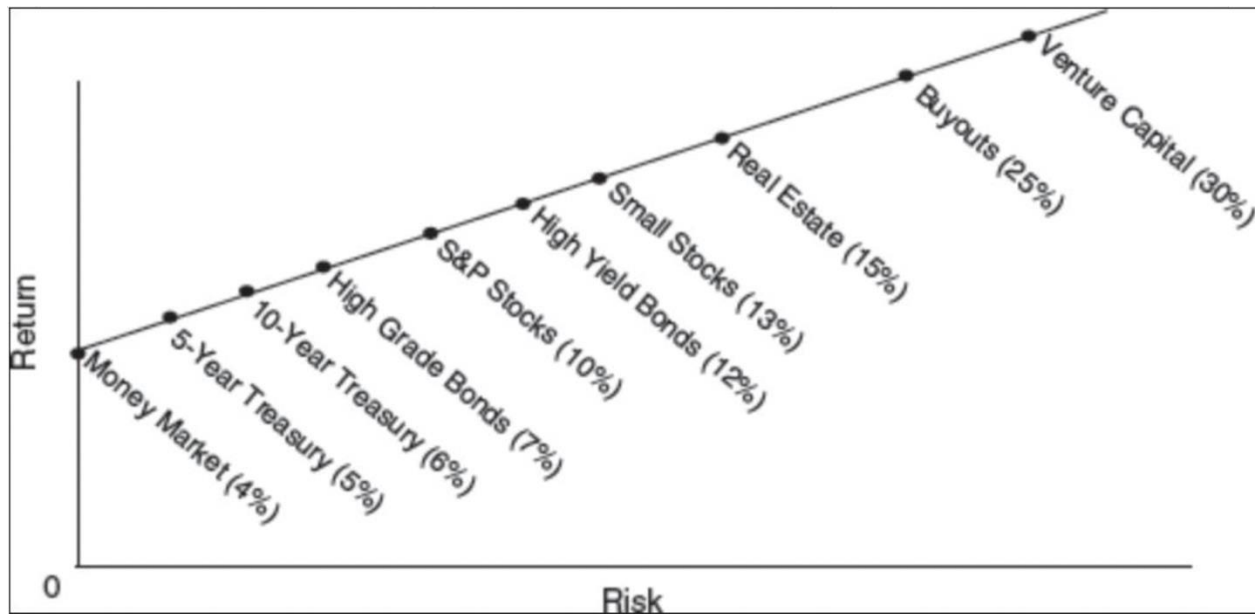
The early years were incredibly precarious, Musk says, *"I had one of the most difficult choices I have ever faced in life in 2008. And I think I had maybe \$30 or \$40 million left, and I had two choices. I could put it all into one company and then the other company would definitely die, or I could split it between the two companies. But if I split it up between the two companies, they both might die."*

Neither company has died. With November's successful launch of Starship, SpaceX has now had 285 launches, 248 landings, and 220 reflights. The company is constantly launching satellites, ferrying cargo and passengers to the International Space Station, and running the Starlink communications network.

Just think how close they were to failure; how close the employees and early investors were to losing everything. The first three launches of the Falcon rocket were all spectacular failures. The third launch failed due to a busted nut that eventually caused a fuel leak during the launch. That nut was all that stood between total bankruptcy and one of the most valuable private companies in the world. That's right, the private company SpaceX has a private market value of \$150 billion, which is larger than both Boeing or Raytheon. The fourth launch succeeded, and we are all now witnessing a new space revolution.

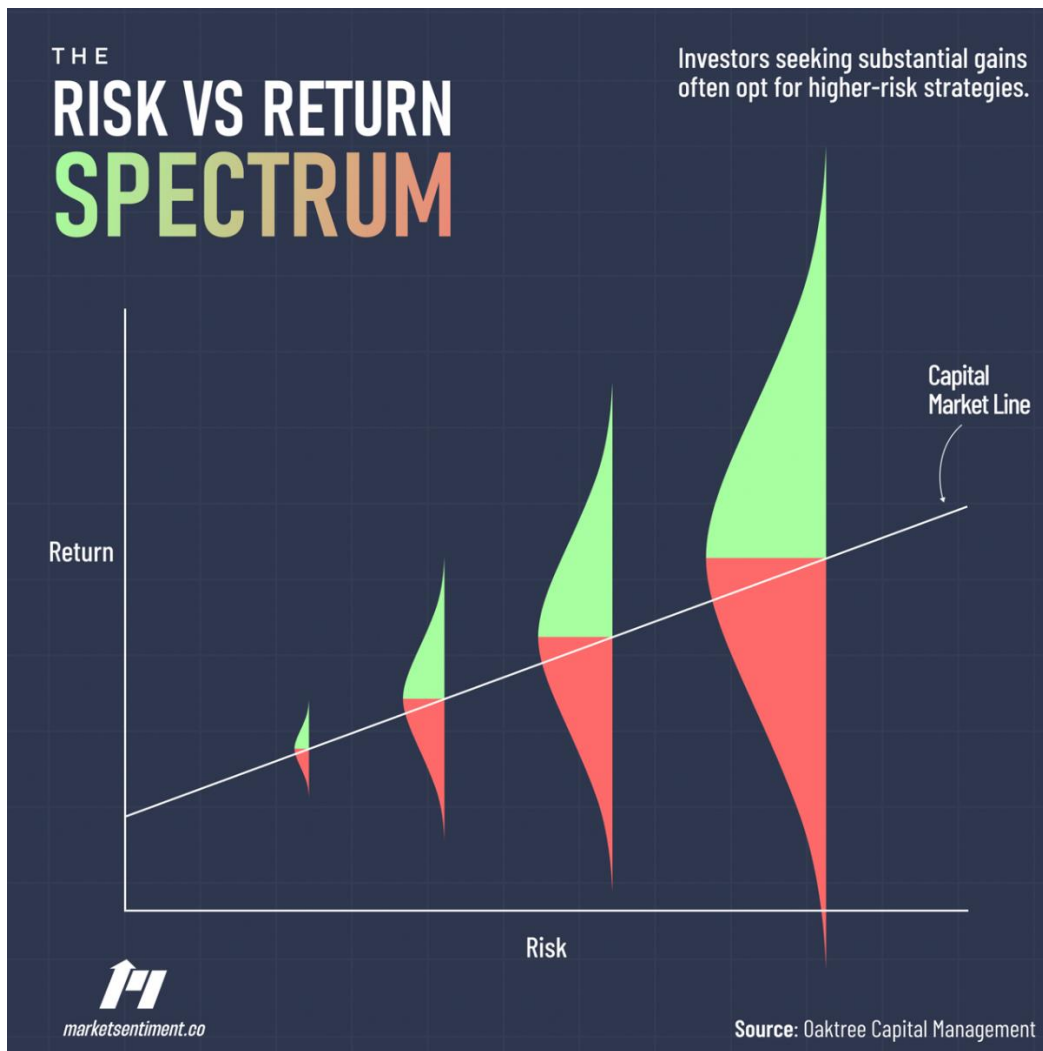
There are very few individuals like Elon Musk, those individuals with above average intelligence, work ethic, and a willingness to not only take on risks but to embrace risk. They seem to thrive in chaos. Most of us would prefer to manage risk, reduce it, and avoid chaos.

Generally, when we think of Risk/Reward in investing we think of the graphic below, where we have low-risk/low-return cash at one end and high-risk/high-return venture capital at the other end. The premise is simple, you don't invest in something riskier unless you are compensated for that risk.



The problem with the above approach to looking at risk is that it only shows the positive relationship between risk and reward. In good times, you would simply invest in those assets that offer the highest returns.

The correct way to think about risk is that the riskier investments offer the **prospect** of a higher return, not a **guarantee** of a higher return. A better way to look at the Risk/Reward spectrum is below. Here we see that the range of potential outcomes may be more important than the average.



We see this manifest itself every year in the stock market. We often talk about the S&P 500 delivering 10% annually on average, while the reality is that it rarely delivers that in any given year. If you go in expecting a 10% return every year, you're more likely than not to be disappointed. The graphic below shows all of the annual returns on the S&P 500 since 1926, and as you can see there are very few years where the actual return was 10%. The range of outcomes can be quite large.



(Source: Ben Carlson, A Wealth Of Common Sense)

Returns (or Rewards) can be very volatile from year-to-year. The total return on the S&P 500 was 28.75% in 2021, -18.17% in 2022, and so far in 2023 we're at 20.68%. What exactly drives that total return? Let's take a deeper dive.

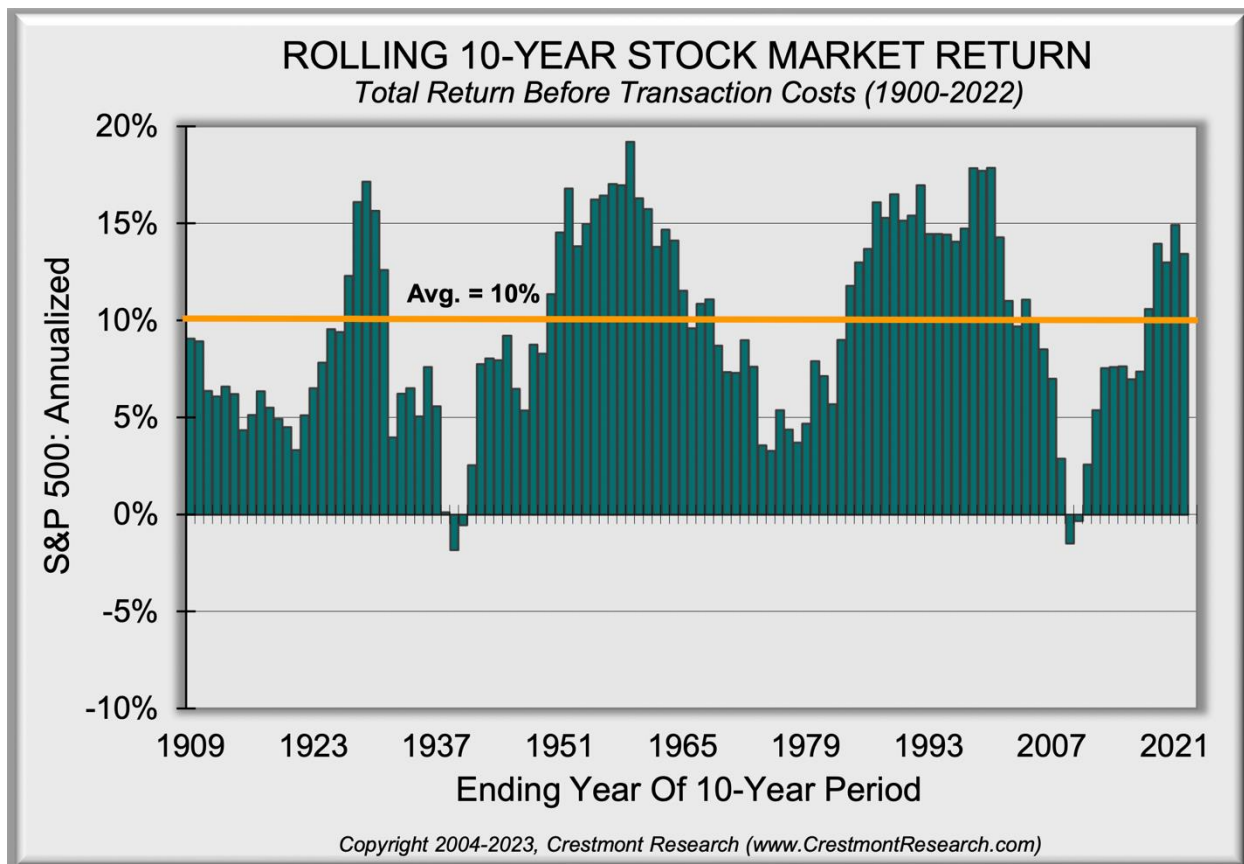
I've often said that the total return of a stock or the stock market could be broken down as follows:

Total Return = Dividend Yield + Earnings per Share Growth + P/E Expansion or Contraction

Historically (since 1926) the S&P 500 has returned about 10.1% annually on average. That 10.1% was made up as follows:

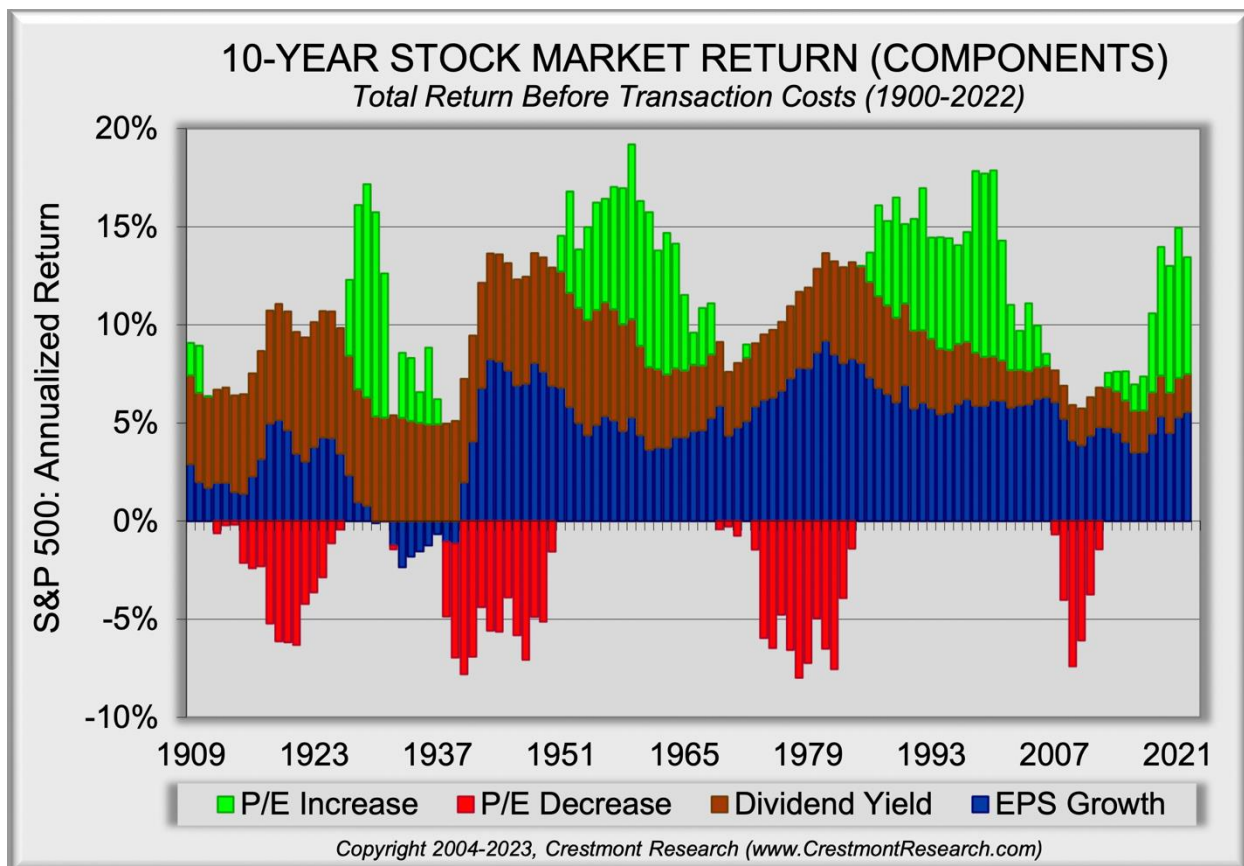
$$\begin{aligned} \text{Tot Ret} &= \text{Div Yld.} + \text{EPSg} + \text{P/E Change} \\ 10.1\% &= 4.3\% + 5.2\% + 0.6\% \end{aligned}$$

The graphic below from Crestmont Research shows the rolling 10-year total returns for the S&P 500 over the last 122 years. Again, even though the average was 10%, notice how we spent many 10-year periods of time either above or below that 10% line.



Another great chart from Crestmont takes this data one step further and breaks down the rolling 10-year returns into its three basic components; dividends, earnings growth, and change in price-to-earnings. Notice how the rolling 10-year P/E's have been expanding ever since the Great Financial Recession of 2008.

Generally, when P/E's are expanding we have returns over the long-term average of 10%, and when P/E's are contracting returns fall below the long-term average.



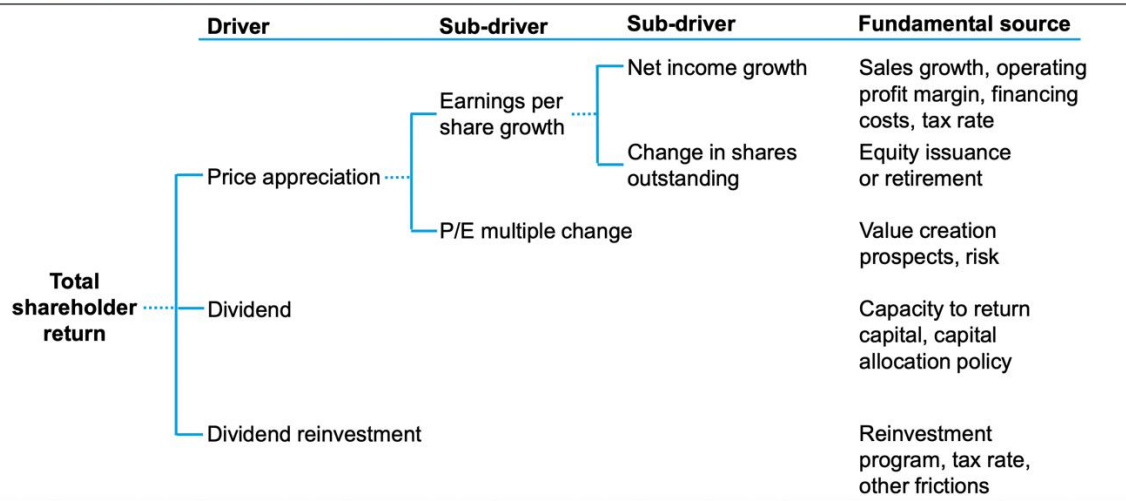
Diving a little deeper into the components of total return is an excellent piece from Michael Mauboussin at Morgan Stanley, titled Total Shareholder Return – Linking the Drivers of Total Returns to Fundamentals.

https://www.morganstanley.com/im/publication/insights/articles/article_totalshareholderreturns.pdf?1701181001153

Mauboussin takes our simple total return formula and adds a couple of drivers, such as dividend reinvestment and the change in shares outstanding. He also takes a hard look at the Fundamental Sources of the various drivers. For example:

- Earnings Growth is a function of sales growth, operating profit margin, financing costs, and tax rates.
- P/E Multiple Change is a function of how investors perceive the prospects of future value creation as well as risk. Generally, PE's expand when investors feel confident that value creation will be positive and risk is declining. PE's contract when growth prospects contract and/or risk increases. This often coincides with changes in interest rates.
- Dividends and dividend reinvestment are a function of a companies capital allocation policy and an individuals spending and tax decisions.

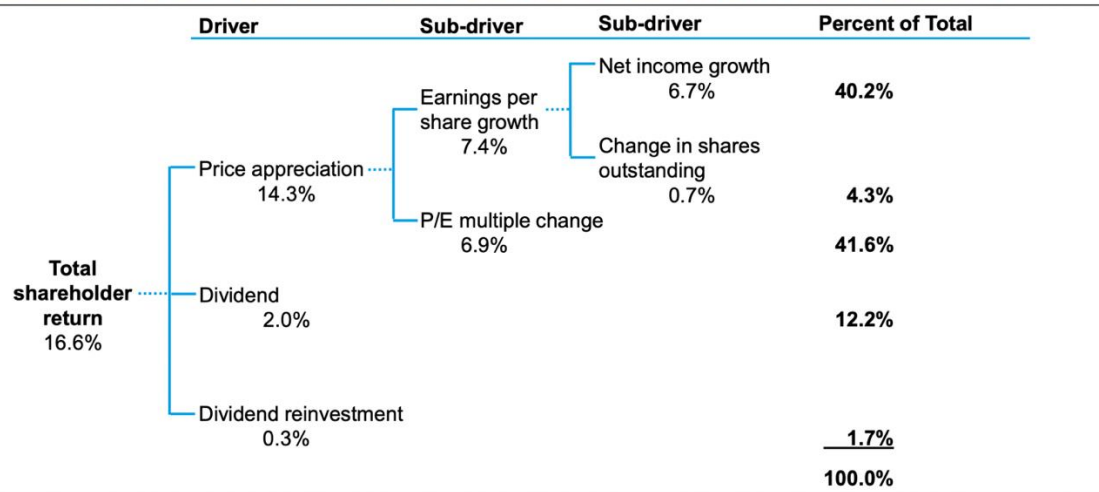
Exhibit 1: Drivers of Total Shareholder Return



Source: Counterpoint Global.

The following graphic shows the 10-year period ending 2021 for the S&P 500. This was an exceptionally lucrative period for equity investors, where the average annual return was 16.6%. As we can see, earnings per share growth accounted for 7.4% of that 16.6% total return, or 44.5% of the total. Forward PE multiples expanded from around 14x to 24x, which accounted for 6.9% of the total return, or 41.6% of the total. A dividend yield of 2% plus 0.3% dividend reinvestment contributed 2.3%, or the final 13.9% of the total return.

Exhibit 2: Drivers of Total Shareholder Return for the S&P 500, 2012-2021 Annualized



Source: FactSet and Counterpoint Global.

Another interesting graphic from Mauboussin's work compares the total return contribution differences between the S&P Value and S&P Growth indices. Since 2007, Growth stocks have outperformed Value stocks 13.3% annually versus 7.6% annually. Even though value stocks had a higher dividend yield of 2.6% versus 1.6%, growth stocks more than made up for that by having EPS growth of 8.0% versus value's EPS growth of only 3.3%. P/E multiples also expanded more for Growth stocks versus Value stocks, 3.6% vs. 1.6%.

Exhibit 16: Tale of the TSR: S&P 500 Value versus S&P 500 Growth, 2007-2021 Annualized

	Value	Growth
Net income	5.2%	5.9%
+ Shares outstanding	-1.9%	2.0%
= EPS growth	3.3%	8.0%
+ Multiple expansion	1.6%	3.6%
= Price appreciation	4.8%	11.6%
+ Dividend yield	2.6%	1.6%
+ Dividend reinvestment	<u>0.1%</u>	<u>0.2%</u>
= Total shareholder return	7.6%	13.3%
<u>TSR contribution:</u>		
Net income	68.5%	44.6%
Shares outstanding	-25.6%	15.1%
Multiple expansion	20.6%	27.2%
Dividend yield	34.8%	11.7%
Dividend reinvestment	<u>1.7%</u>	<u>1.4%</u>
Percent of total	100.0%	100.0%

Source: Counterpoint Global.

It is very interesting that Net Income growth was very similar at 5.2% for Value and 5.9% for Growth. The big difference was that Value stocks issued shares while Growth stocks repurchased shares, this accounted for 3.9% of the 4.7% difference in EPS growth. This analysis should really drive home the importance of looking for companies that have the ability to grow and return capital to shareholders via both share repurchases and dividends.

What can we take away from all of these numbers? I know this is a pretty wonky piece, but bear with me for a few more minutes.

First, diversification is an important tool in mitigating risk, but blindly diversifying along the risk spectrum may actually lead to more risk. It's more important to look at each potential asset separately, and determine what it's current and future return potential is based on its current position on its risk spectrum. For example, if we look at the yield for the 10-year Treasury back in 2020 we see that it was flirting with 0.50%. Clearly Treasuries at that time offered a horrible risk/reward profile. Compare that to today, where 10-Year Treasuries offer returns closer to 4.50%.

10-Year U.S. Treasury Yield



Second, when looking at investing in stocks (either individually or in funds), it is important to breakdown the components of total return to see where historic returns have come from and to help determine where historic returns may be headed. Again, our simple Total Return Model looks like this:

$$\begin{aligned} \text{Tot Ret} &= \text{Div Yld.} + \text{EPSg} + \text{P/E Change} \\ 10.1\% &= 4.3\% + 5.2\% + 0.6\% \end{aligned}$$

How would this model look using current data?

$$\begin{aligned} \text{Tot Ret} &= \text{Div Yld.} + \text{EPSg} + \text{P/E Change} \\ ?\% &= 1.41\% + 11\% + ?\% \end{aligned}$$

Currently the S&P 500 yields 1.41%. Consensus Wall Street estimates have the S&P 500 companies growing earnings from about \$221 in 2023 to \$245 in 2024, or about 11% EPSg. The real question then becomes what do you think will happen to P/E ratios? They are currently at 18.61x the consensus estimate of \$245.

The table below shows a range of possible scenarios and estimated total returns. You can decide if you believe P/E ratios will expand or contract, or if earnings will be higher or lower than current forecasts, and then what your total return would be.

S&P 500 Estimated Return Scenarios										
Estimated Forward Earnings S&P 500										
		\$ 190	\$ 200	\$ 220	\$ 230	\$ 240	\$ 250	\$ 260	\$ 270	\$ 280
	13	-45.83%	-42.97%	-37.27%	-34.42%	-31.57%	-28.72%	-25.87%	-23.02%	-20.16%
	14	-41.66%	-38.59%	-32.45%	-29.38%	-26.31%	-23.23%	-20.16%	-17.09%	-14.02%
	15	-37.49%	-34.20%	-27.62%	-24.33%	-21.04%	-17.75%	-14.46%	-11.17%	-7.88%
	16	-33.32%	-29.81%	-22.80%	-19.29%	-15.78%	-12.27%	-8.76%	-5.25%	-1.74%
Estimated	17	-29.16%	-25.43%	-17.97%	-14.24%	-10.51%	-6.78%	-3.06%	0.67%	4.40%
P/E Ratio	18	-24.99%	-21.04%	-13.15%	-9.20%	-5.25%	-1.30%	2.65%	6.59%	10.54%
	19	-20.82%	-16.65%	-8.32%	-4.15%	0.01%	4.18%	8.35%	12.52%	16.68%
	20	-16.65%	-12.27%	-3.49%	0.89%	5.28%	9.66%	14.05%	18.44%	22.82%
	21	-12.49%	-7.88%	1.33%	5.94%	10.54%	15.15%	19.75%	24.36%	28.97%
	22	-8.32%	-3.49%	6.16%	10.98%	15.81%	20.63%	25.46%	30.28%	35.11%
	23	-4.15%	0.89%	10.98%	16.03%	21.07%	26.11%	31.16%	36.20%	41.25%
Current (11/24/23) S&P 500 Price \$4,559										
Current 12-month Forward Earnings Estimate \$245										
Current S&P 500 P/E 18.61x										

Here at Medallion Wealth Management, we take a serious, dynamic view of each asset's current valuation and prospects when we build out a client's asset allocation. It is critical to not only look at how assets have performed historically, but also where they are positioned currently and their future prospects. This requires a thoughtful analysis of historic risk/reward scenarios as well as a sober look at current valuations and prospects. Investing is not a static exercise; the sand is constantly shifting.

***Nothin' lasts forever
And we both know hearts can change
And it's hard to hold a candle
In the cold November rain***

As always, be careful out there.

Chris Wiles, CFA



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