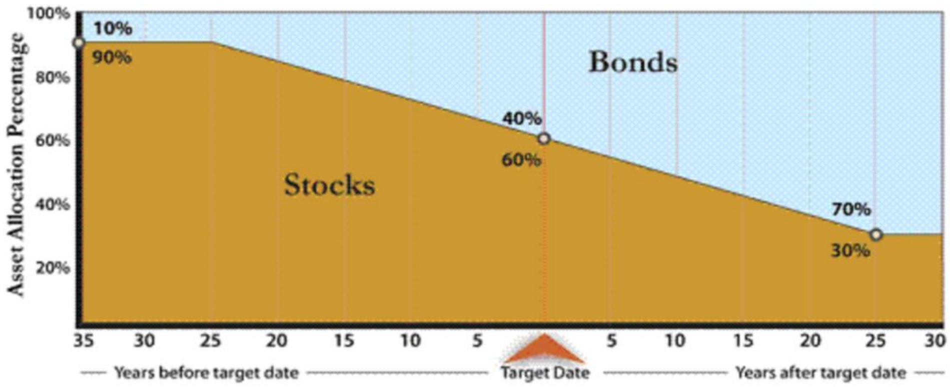
September 2024 Market Commentary

*The Code is More What You'd Call Guidelines Than Actual Rules*

***Barbossa - "First, your return to shore was not part of our negotiations nor our agreement so I must do nothing. And secondly, you must be a pirate for the pirate's code to apply and you're not. And thirdly, the code is more what you'd call "guidelines" than actual rules. Welcome aboard the Black Pearl, Miss Turner."***
***Pirates of the Caribbean*** - https://www.youtube.com/watch?v=WJVBvvS57j0

I've never been a fan of **"rules"** when it comes to investing, but the marketing people, who too often populate the upper echelons of many investment companies, love them. Simple rules-based portfolios are easy to sell and easy to manage. Whether or not they make sense for investors is another question altogether. Hence, we've seen a proliferation of cookie cutter asset allocations and investment portfolios being sold. The reality though is that the world is way too dynamic for rules, guidelines maybe, but not rules.

Let's take a look at the very popular retirement plan product in many 401-K funds, the Target-Date Funds. Amazingly roughly 75% of investors use a target-date fund in their retirement plan. These funds typically have a year in their name, such as 2050, which approximately coincides with when you expect to retire. The idea is simple: As you age the composition of the fund changes, following a glidepath from mostly stocks in the beginning, to mostly bonds by retirement.




Source: Securities and Exchange Commission.

The premise for these funds makes a lot of sense intuitively: First, younger investors generally have smaller portfolios and can tolerate more stock market volatility better than older people. Second, those approaching retirement have more to lose, and cannot withstand a big drop in their portfolio. Sounds reasonable doesn't it, no wonder 75% of investors sign up, the problem is it doesn't work.

You see, the world is constantly changing and the future is unknown. In fact, looking at the past 141 years, the exact opposite strategy would have been preferable. Rob Arnott and his team at Research Affiliates, took a look at the target-date fund approach from 1871-2011. They compiled performance data for 101 simulated investors, each of whom began their 40-year working careers one year apart and contributed $1,000 to their account each year.

The results are in the table below. Prudent Polly follows the normal glidepath target-date approach starting at 80% stocks and 20% bonds. Balanced Burt uses a static 50/50% approach. And Contrary Connie uses the inverse glidepath, starting with 20% stocks and 80% bonds, meaning that she will retire with 80% stocks and 20% bonds.

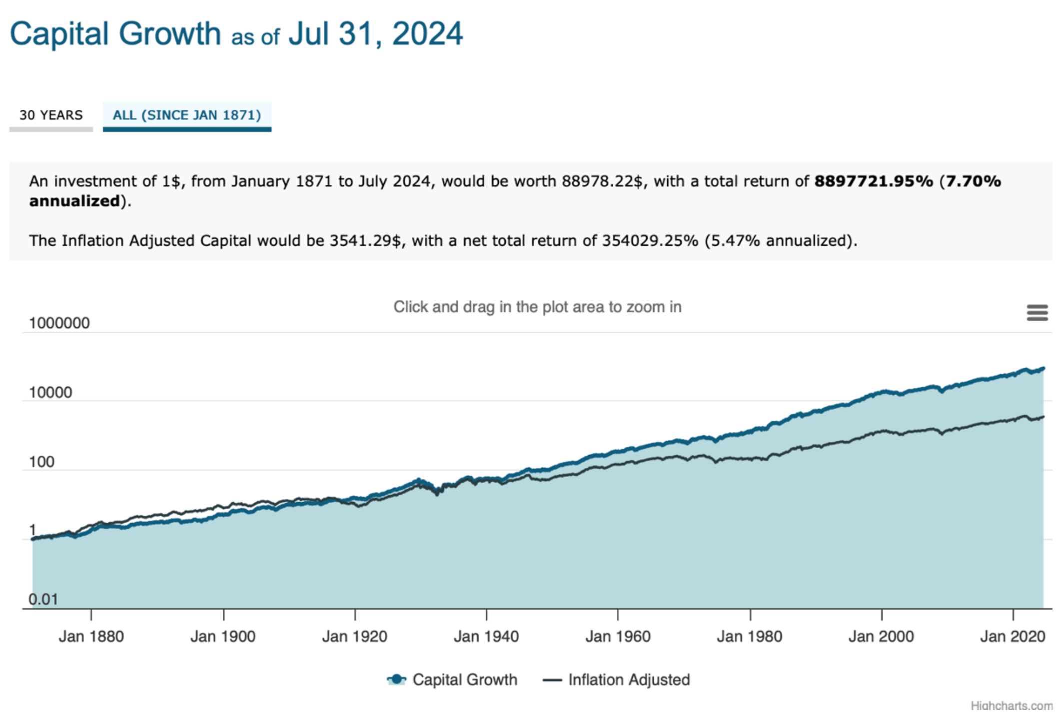
## Table 1. A Comparison of Retirement Strategies, 1871–2011

| | Prudent Polly Glidepath 80→20 | Balanced Burt Static Mix 50/50 | Contrary Connie Inverse Glidepath 20→80 |
|---|---|---|---|
| **Panel A. Ending Retirement Assets** | | | |
| Average | $124,460 | $137,870 | $152,060 |
| Standard deviation | $37,670 | $41,250 | $57,010 |
| Min | $49,940 | $51,800 | $53,040 |
| 10 percentile | $73,550 | $78,820 | $79,300 |
| 50 percentile | $119,760 | $142,620 | $148,240 |
| 90 percentile | $177,400 | $184,090 | $227,670 |
| Max | $211,330 | $209,110 | $286,920 |
| 90% / 10% ratio | 2.41 | 2.34 | 2.87 |

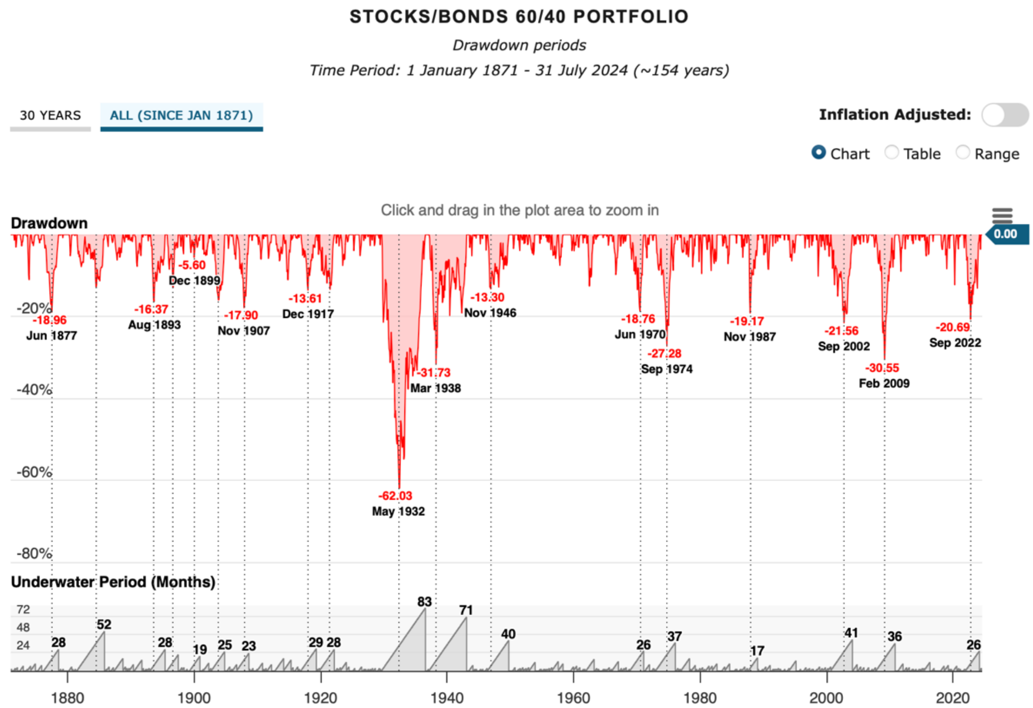
There are a lot of numbers to unpack here. First, after investing $41,000 over a 40-year career, Polly has $124,460, Burt has $137,870, and Connie has $152,060. Connie is the clear winner, but she had to tolerate $57,010 in volatility (standard deviation) versus Polly's volatility of only $37,670. The problem with volatility (standard deviation) as a risk measure is that it treats upside volatility the same as downside volatility. Connie happily accepted the upside volatility.

Does this mean we should all follow Connie and adopt the contrary strategy of more stocks later in life? **Absolutely not!** All Connie proved is that historically it made sense to be more aggressive with your asset allocation. **None of these results have any bearing on what may happen in the future.**

Let's take a look at another rules-based allocation strategy, the simple 60/40% portfolio, where 60% is invested in stocks and 40% invested in bonds, rebalancing annually.




While the chart above makes it look like you had a fairly nice gradual climb higher, the reality in the chart below shows that you've had more than a few periods of unpleasantness.




While there is often talk of a 9% average annual return (shown below with the dotted line), the truth is that we rarely actually experience 9% returns. We are often significantly above or below average.

**Annual Return for a Portfolio in 60% Stocks and 40% Bonds**

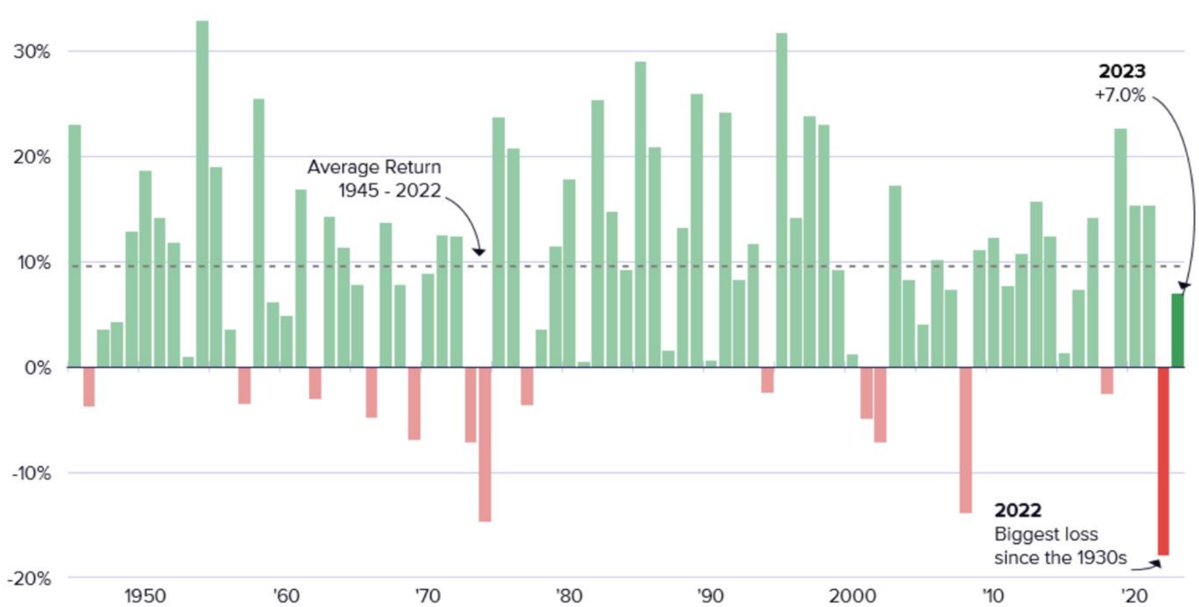



*Figure for 2023 is through September.
Source: Stern NYU

The message here is that "rules" don't work in the real world. Guidelines may be useful, but there are no guarantees. Investors need to be realistic and flexible when looking at current and expected returns. They also need to be prepared to save aggressively, spend cautiously, and work a few years longer (because we live longer).

Common sense is your best friend. Who would have thought we'd have nearly a decade of zero percent interest rates. Did it make sense to allocate much money to bonds when they were yielding nearly zero percent? Probably not, but that is exactly what these formulaic investment strategies did.

All good pirates know that you need to keep your options open (keep your portfolio liquid and flexible), so you have the ability to change course as the markets change and present you with new risks and opportunities.

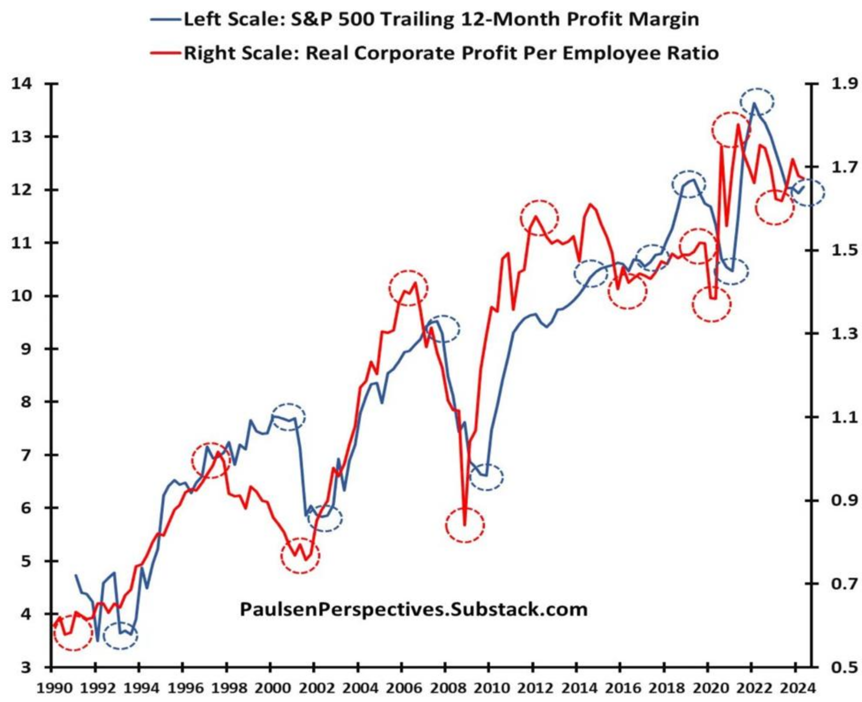
**Market Commentary:**

August reminded us of just how quickly risks and opportunities can present themselves. The stock market started the month with a quick three-day plunge of about 7%, followed by a nearly as quick 8% rally. The market was initially spooked by an unexpectedly large employment miss, combined with a rate hike in Japan, and Warren Buffett selling half of his Apple stock (raising his cash levels to 25% of assets). But upon further review; the economy isn't slowing that drastically (and the Fed is going to start cutting rates), Japan isn't hiking rates that dramatically, and Mr. Buffett is simply managing a massively overweight position. All is well in the world.

One of the biggest stories of the last forty years has been the dramatic improvement in corporate efficiency and profitability. Back in the 1980's it took about eight employees to generate $1M in revenue, today it takes about two.

This coincides with profit margins increasing from 4% to 13%, and real corporate profit per employee increasing from 0.6 to 1.7.

**Chart 3: S&P 500 Profit Margin vs. Real Profit Per Job**




Not only are profit margins higher overall, the largest companies have the highest margins and the highest earnings growth rates. We are evolving into a world where economies of scale are rewarded like never before.

**Exhibit 1: S&P 500 EPS grew by 11% year/year in 2Q**

as of August 15, 2024; reflects realized 2Q data for 93% of S&P 500 companies

| | 2Q 2024 realized and bottom-up consensus (y/y) | | | | |
|---|---|---|---|---|---|
| | EPS | SPS | Margin | | Median stock |
| Sector | Growth | Growth | Level | Change | EPS growth |
| Utilities | 21 % | NM | NM | NM | 15 % |
| Info Tech | 19 | 13 | 25.2 | 142 | 8 |
| Financials | 18 | NM | NM | NM | 12 |
| Health Care | 16 | 6 | 8.3 | 67 | 9 |
| Consumer Discretionary | 12 | 3 | 9.2 | 74 | 9 |
| Consumer Staples | 4 | 3 | 6.9 | 8 | 3 |
| Comm Services | 3 | 4 | 14.7 | (19) | 6 |
| Industrials | 0 | 4 | 10.7 | (44) | 9 |
| Real Estate | (0) | NM | NM | NM | 3 |
| Energy | (2) | 6 | 9.1 | (77) | 10 |
| Materials | (8) | (5) | 11.4 | (46) | 8 |
| **S&P 500** | 11 % | | | | 8 % |
| *ex. Financials and Utilities* | 9 | 5 % | 11.4 % | 40 bp | 8 |
| Magnificent 6 | 36 % | 15 % | 23.6 % | 371 bp | |
| S&P 494 | 6 | 4 | 9.6 | (21) | |

Source: FactSet, Goldman Sachs Global Investment Research

## Rational Expectations:

Let’s take a look at our current market environment and make some rational expectations about what the future may hold:

- **Cash** – The current yield on most cash type instruments is about 5.25%. With the Fed telegraphing interest rate cuts beginning in September, it is probably safe to forecast Cash returns over the next year at **less than 5.25%.**
- **Bonds** – The return on bonds is very close to the yield-to-maturity at the time of purchase.
  - US 10-Year Treasury **3.82%**
  - US Corporate BBB **5.07%**
  - US Corporate High-Yield **7.28%**

  If you purchase bonds with these yields, you should get very close to these annual returns. Of course, if we have a difficult recession, corporate defaults will rise and your returns on the corporate bonds will be lower.
- **Stocks** – There are a lot of factors that go into forecasting stock returns, but the most important are the current price, the dividend yield, the projected earnings, and the price-to-earnings ratio (P/E). The table below can be used to map out various return scenarios that you believe may happen.
  - If you believe earnings one year out will be near the forecasted amount of $275, and the P/E will expand slightly to 21x, then you can expect a return of about 4%.
  - If you think we may have a recession, and earnings are only $260, and P/E’s will contract to 18x with slower growth, then you can expect a return of -15%.
  - If you believe earnings will be stronger than expected, say $280, and P/E’s will expand due to lower rates to 23x, then you can expect a return of 15%.

**S&P 500 Estimated Return Scenarios**

**Estimated Forward Earnings S&P 500**

| | | $ 240 | $ 250 | $ 260 | $ 270 | $ 275 | $ 280 | $ 290 | $ 300 |
|---|---|---|---|---|---|---|---|---|---|
| | **17** | -26.14% | -23.11% | -20.08% | -17.06% | -15.55% | -14.03% | -11.01% | -7.98% |
| | **18** | -21.86% | -18.66% | -15.46% | -12.25% | -10.65% | -9.05% | -5.84% | -2.64% |
| | **19** | -17.59% | -14.21% | -10.83% | -7.45% | -5.76% | -4.06% | -0.68% | 2.70% |
| | **20** | -13.32% | -9.76% | -6.20% | -2.64% | -0.86% | 0.92% | 4.48% | 8.04% |
| **Estimated** | **21** | -9.05% | -5.31% | -1.57% | 2.17% | 4.03% | 5.90% | 9.64% | 13.38% |
| **P/E Ratio** | **22** | -4.78% | -0.86% | 3.06% | 6.97% | 8.93% | 10.89% | 14.80% | 18.72% |
| | **23** | -0.50% | 3.59% | 7.68% | 11.78% | 13.82% | 15.87% | 19.97% | 24.06% |
| | **24** | 3.77% | 8.04% | 12.31% | 16.58% | 18.72% | 20.86% | 25.13% | 29.40% |
| | **25** | 8.04% | 12.49% | 16.94% | 21.39% | 23.61% | 25.84% | 30.29% | 34.74% |

Source - Yardeni Research

**Current (8/26/24) S&P 500 Price 5,618**

**Current 12-month Forward Earnings Estimate $275**

**Current Dividend Yield 1.24%**

**Current S&P 500 P/E on Forward Earnings of $275 = 20.4x**

This newsletter spent a lot of time talking about silly investment rules, and not so silly rational expectations. Hopefully I planted a few seeds for further discussions with your investment advisor. Discussions that are more centered around guidelines that fit your unique circumstances as well as risk tolerance, framed in a world of current rational expectations.

As always, be careful out there.

Chris Wiles, CFA

Where trust is Earned