INVESTMENT UPDATE

Math, Myths & the Art of Investing in "Expensive" Markets

It's more than fair to characterize the current investment landscape as expensive.

WHY?

US equities traded +64% from October 2022 through year end 2024. The S&P 500 trades at around 22x forward earnings (vs. a 30-year average of ~17x), placing current valuations among the most expensive levels in our clients' investment lives. Earnings are projected to grow by double digits in 2024, but that's fully baked into the valuations. Capital spending on AI is slated to continue at a torrid pace. Also priced in! Tariffs... priced in?

As the graphic below depicts, starting valuations can be useful in setting expectations as one looks forward. Valuations alone are not explicitly predictive but relevant. History would suggest that the probability of double digit returns for over the next 5 years is modest.

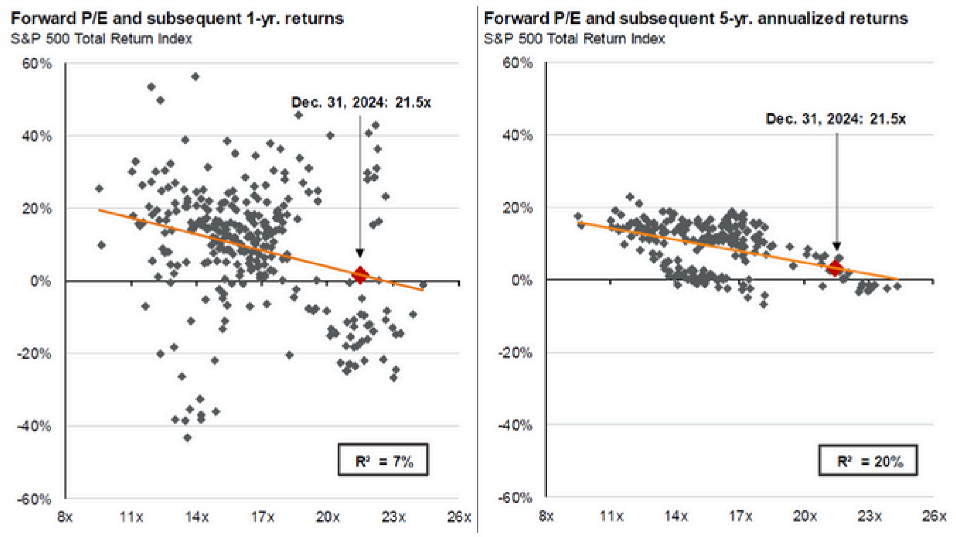
Must this end poorly?

No! The "hall of fame" names of investing each earned recognition by outperforming peers and markets when times became tougher. Buffett, Dalio, Evillard, Templeton, Ackman...disciplined investors who refused to chase expensive markets. Each stuck to his discipline, stayed patient, and waited for entry points that offered an opportunity to generate the returns he felt compensated him fully for the level of risk taken.

One of the most difficult tasks as a portfolio manager is...NOTHING! Sometimes you can be right on every part of a thesis but early on the timing of when you will be rewarded. Patience is key.

Should I just go to the sidelines and wait for a better entry point?

No! As referenced above, it can be disconcerting and humbling to be defensive too early in a cycle.That doesn't mean you won't be rewarded.What is seldom rewarded is market timing. None of the "hall of fame" investors earned their reputation by market timing. None!



Source: FactSet, Refinitiv Datastream, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management.
Returns are 12-month and 60-month annualized total returns, measured monthly, beginning 12/31/1999. R^2 represents the percent of total variation in total returns that can be explained by forward price-to-earnings ratios. Price-to-earnings is price divided by consensus analyst estimates of earnings per share for the next 12 months as provided by IBES since May 1999 and by FactSet since January 2022.
Guide to the Markets – U.S. Data are as of December 31, 2024.

J.P.Morgan ASSET MANAGEMENT

We believe one of the essentials today is maintaining sufficient liquidity to allow yourself the ability to capitalize should a selloff ensue. "Dry powder", as some call it, can take the form of short-duration fixed income and assets that have low correlations to equities. Such investments may offer smaller upside than equities, but lower volatility and seek to outpace cash yields. These are the positions we would look to trim to be opportunistic in the event of a selloff. This is not market timing, but tactical rotation. This is an acknowledgement that you would eventually like to own more risk assets at a better price.

But bonds...

We've written extensively over the last 2 years about our non-traditional positioning in fixed income. This positioning has garnered us tremendous outperformance versus the Bloomberg Aggregate Bond Index (approx. 5% outperformance per annum). We believe our current positioning in fixed income will again provide us opportunity to post a mid/high single digits in 2025, whether the Federal Reserve cuts further or not.

For more than 2 years investors have tried (and largely lost) the guessing game of interest rates. We simply haven't taken the bait to make such a bet. Instead, we believe the math of the securitized fixed income markets and the math of remains biased to short duration bonds. This goes back to the "dry powder" and flexibility referenced earlier. We seek resilient and low-correlated assets that can provide us with the capital to reallocate if/when there is a move lower in the price of risk assets.

Contrarian thoughts

We touched on S&P 500 valuations earlier. US Small/Mid cap stocks trade at valuations far more reasonable relative to historical levels. Furthermore, small caps and mid-caps indices show projected earnings growth rates faster than their large cap peers.

Neither small caps nor mid-caps are homogenous asset classes (~40% of the Russell 2000 have no profits), thus active management and security selection have historically proven valuable.And therein lies the potential opportunity...to buy more "cheaply" priced companies with faster projected earnings growth. Avoiding companies in these indices with significant balance sheet leverage and floating rate debt is also prudent!

Even less consensus is a belief that non-US equities can emerge from a decade plus lag versus US peers.Candidly, they may not outperform US Stocks any time soon. What is true is that there are many great companies and great brands domiciled overseas that trade at significant discounts relative to both history and US peers. Therein lies an element of protection because the price paid ultimately matters in the math of returns. A 'cheap" dividend grower is seldom proven to be a poor long-term investment, despite short-term relative underperformance.

Cash Flow

A final "weapon" we are embracing against somewhat expensive markets is cash flow strategies. If expectations for appreciation are lower, one's cash flow proves increasing valuable as a means of total return and as a volatility dampener. Said another way, a 3-4% cash flow instrument doesn't stand out in a 20% total return world.That same 3-4% cash flow looks very attractive when expectations for total return are nearer 6-8%.

Over the last few years our team has increasingly invested in strategies (both in equities and fixed income) that provide cash flow to the portfolio. Among these are dividend-focused equity, covered call ETFs, and credit strategies. It is typical to see a current 60/40 profile portfolio with a cash generation of more than 4% per annum on the whole portfolio (not just the bond portion)!

In Summation…

Over the coming months investors are likely to be bombarded with headlines designed to evoke fear, panic, anxiety, and unrest. WHY? Because that's what sells advertisements and draws viewers to their platform.Some of it will be warranted and much of it will be proven to be nothing more than noise.

We remain focused on the task at hand. Today's markets demand focus, decisiveness, conviction and patience. We work every day to ensure that we have considered / accounted for every knowable risk. We do not seek to avoid or hedge every possible risk, for such a portfolio would offer no potential for return.Instead, we seek exposure to the risks we deem to offer the best potential compensation for the risk taken. We believe seeking solutions outside the S&P 500 and outside the framework of a traditional "long only" management style can prove beneficial.

Sometimes complex solutions provide the same types of returns as simple solutions. That perfectly acceptable because there are other times (and typically times where returns are harder to come by) that such "sophisticated" strategies can provide tremendous added value. We believe we are closer to such times than we were and that our patience and discipline will be rewarded and will reward our clients. ***Markets aren't cheap and we fully acknowledge that reality (and are positioned accordingly)!***

Contrarian thoughts

We touched on S&P 500 valuations earlier. US Small/Mid cap stocks trade at valuations far more reasonable relative to historical levels. Furthermore, small caps and mid-caps indices show projected earnings growth rates faster than their large cap peers.

Neither small caps nor mid-caps are homogenous asset classes (~40% of the Russell 2000 have no profits), thus active management and security selection have historically proven valuable.And therein lies the potential opportunity…to buy more "cheaply" priced companies with faster projected earnings growth. Avoiding companies in these indices with significant balance sheet leverage and floating rate debt is also prudent!

HEAD INVESTMENT PARTNERS

2280 Valley Vista Road, Knoxville, TN 37932
865-999-5332