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Cadence clips

FOCUSED ON WHAT MATTERS MOST.

Taking Stock

By Casey Clarke

With one month to go before we put this year to bed, we're all eagerly embracing the holidays, the snow, shoveling the driveway – heck, anything is a welcome distraction from the drama that's unfolded in 2022. There's an interesting irony to the way the market pain has been distributed in this extra socially aware, fairness-focused era we find ourselves in currently – which is to say, the losses have been dished out relatively equally and ubiquitously. As unfair as it feels to experience losses, we can take comfort in knowing that most everybody got similar treatment. Of course, in markets, not everybody can experience the same outcome over longer stretches. For every seller, there's a buyer, which means as long as all assets aren't moving in the same direction in perpetuity, there are clear winners and losers over time - so it's probably wise not to get too used to this broad application of losses (or gains in better times). In the end, investors who put in the effort to educate themselves, apply discipline, and think critically will undoubtedly come out ahead. We're looking forward to that as we head into next year, but for now the story has been one of broad asset deflation.

As Steve will focus on in the next article, just about every asset class remains down this year, with some such as cryptocurrency and high tech down a lot. The timing and magnitude of declines has followed the usual playbook with the most inflated and speculative asset classes being hit first and hardest. The highest quality assets have fared better, but they're largely struggling as well. What has made this market cycle downturn worse than many prior, so far, has been the decline in high quality bonds. With rates at record lows as inflation ramped up in 2021, the already expensive bond market got caught offsides at precisely the wrong time in the cycle. What usually provides shelter from a stock market storm has been reeling from Federal Reserve rate increases and the uncertainty around inflation that is already too high for comfort. In addition, the massive leverage that accumulated over time in sovereign debt markets in an effort to boost historically low yields has magnified the selling and losses. Even though we're probably closer to the end of this bond market route than the beginning, as we mentioned in our letter last month, the volatility has been historic. Whether in stocks or bonds, and regard-

less of the mix between the two, losses have been on the order of -15% to -25% so far this year (Most of our clients have fared better).

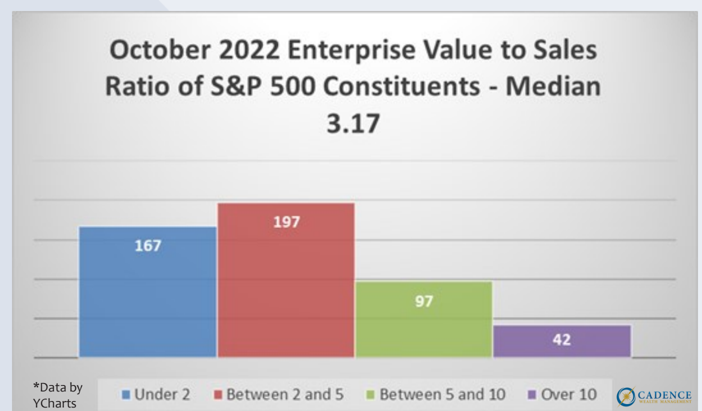
So, where does that leave us? As I mentioned, we feel the outlook for bonds is now much better than for that of stocks. With rates up around 4% and inflation likely to come down sharper than most are expecting (the rate not the level) due to fairly rapidly slowing growth, bonds should look increasingly appealing in time. The broad stock market on the other hand is still suffering from excessive valuations in the face of a slowing economy – not a good combination. Currently, the median enterprise value (market capitalization plus debt) to sales ratio of the S&P 500 is 3.17. This is high even after a -17% decline in the S&P 500 already, which as we've written in recent months, indicates there's still a fair amount of air left in the balloon. The EV/S ratio essentially measures how long it would take an investor to get her investment back if the company returned 100% of its sales to the investor as it made them. In this case, our investor would get her money back in just over 3 years. Of course, companies have costs, and so in practice it takes much longer to return capital to shareholders, but given that sales are much harder to manipulate than earnings, it's typically a much better metric to use when trying to quickly gauge valuation. In addition to the median ratio for the broad market being high, the number of companies in the S&P 500 with an EV/S ratio over 5 stands at 139, while there are 42 companies in the S&P 500 with EV/S ratios over 10! Anyone close to financial markets during the tech bubble decline between 2000 and 2003 might recall the quote in 2002 from the CEO of Sun MicroSystems, Scott McNealy, in reference to his company's epic stock price decline the prior two years:

> *"At 10 times revenues, to give you a 10-year payback, I have to pay you 100% of revenues for 10 straight years in dividends. That assumes I can get that by my shareholders. That assumes I have zero cost of goods sold, which is very hard for a computer company. That assumes zero expenses, which is really hard with 39,000 employees. That assumes I pay no taxes, which is very hard. And that assumes you pay no taxes on your dividends, which is kind of illegal. And that assumes with zero R&D for the next 10 years, I can maintain the current revenue run rate. Now, having done that, would any of you like to buy my stock at $64? Do you realize how ridiculous those basic assumptions are? You don't need any transparency. You don't need any footnotes. What were you thinking?"*

What we'd argue is that the same case can be made for companies trading over 5x sales and even 3x sales. When the growth cycle and concomitant market cycle turn lower, investors stop dreaming and start thinking. This paradigm shift always takes valuation ratios lower as investors start contemplating the questions Scott McNealy was raising. At the bottom of the two most recent recessionary periods and stock bear markets, the median EV/S ratios were 1.80 and 1.60 in 2009 and 2003 respectively. It's important to note that in the charts that follow, we're only able to view data on the S&P 500 companies that are still in the index today. Over time, companies that experience stagnating stock prices and growth rates, or that simply go out of business can fall out of the index and no longer be reflected in the statistics. This can serve to make the valuation coming into past bubbles look lower (since many of the most expensive speculative companies subsequently failed) while also skewing valuation levels at the bottom of market cycles. Regardless, there is still information to be gleaned from looking at the distribution of valuations coming into cyclical market peaks as well as coming out of cyclical market bottoms. On the next page, you can see such data for the 2000 and 2007 market peaks.

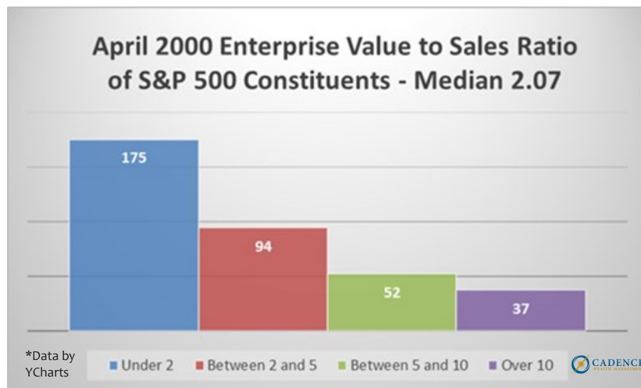
<u>Currently</u>

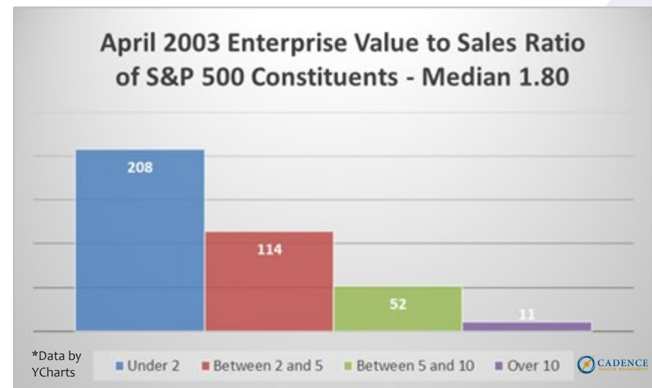
28% of S&P 500 companies have an EV/S ratio over 5!



Tech Bubble Valuation Distribution 2000-2003

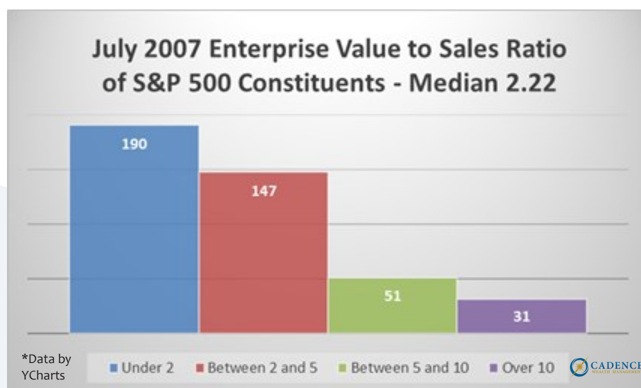
25% of S&P 500 companies have an EV/S ratio over 5

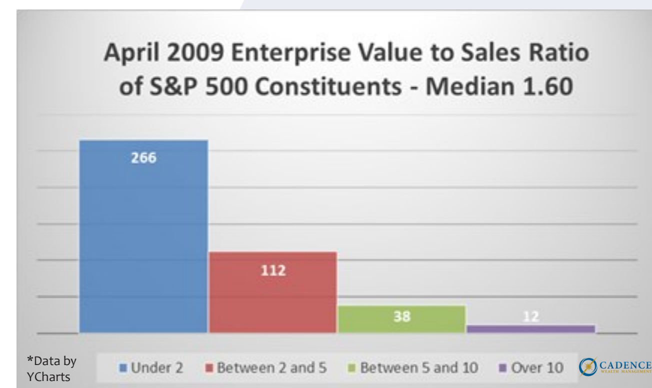




Financial Crisis Valuation Distribution 2007-2009

20% of S&P 500 companies have an EV/S ratio over 5





Plan Smarter, Live Fuller

If I were to summarize all of the above, it would go a little something like this…

- The stock market decline has a lot further to go before speculative excess is removed from prices. There are still a whole lot of people dreaming and not thinking.
- The damage in the bond market is probably close to over, but anything could happen. We expect volatility either way.
- The crypto markets will continue to deflate. Frauds will get revealed and removed. Losses will mount, but whatever survives has a good chance of making it. Whether that's Bitcoin or something else remains to be seen. It's hard to imagine a future without some form of cryptocurrency, even if it turns out to be centrally planned.
- We continue to favor commodities over the longer term, but in the short run, a weakening economy will likely put pressure on most. The exception should be those considered precious, metallic, and potential coinage. Regardless of the trend in price, volatility will likely persist here as well.

- There will be lots of noise in markets given the volatile and dynamic state of the world. Investing will be hard. Doubting oneself will be easy. Those without a process they are confident in will flounder. We are likely headed into a lost decade-plus for investment returns similar to 1929-1954, 1968-1982, and 2000-2012. It's important to keep in mind that this is only a fate those sticking to a traditional "buy and hold at all times" investment strategy are destined to suffer. There is an alternative path and we believe our clients are on it.

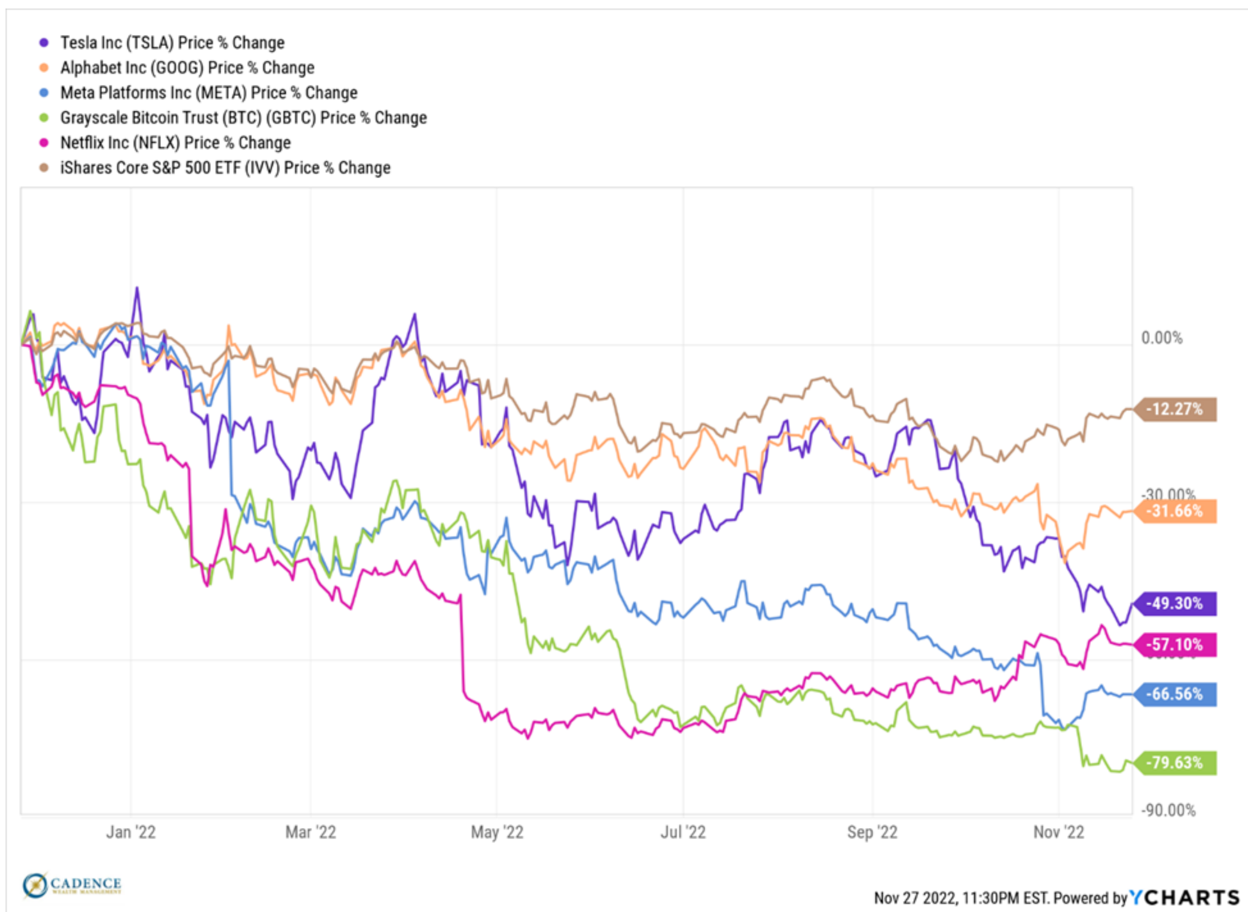
With that in mind, it's important to remember that with a sound, confident plan for the future comes peace of mind and with that peace of mind, the ability to focus on life away from the money. If we're doing everything we can with our financial resources to meet our needs today and into the future, then there's nothing to be gained by dedicating additional brainpower to it. If a tourist is told the road from the airport to the resort will be bumpy and remote, he's much less likely to get worried when he finds himself in the middle of nowhere with a sore rear end. Likewise, markets will continue to be noisy and chaotic. We don't have to like it, but we expect it and we're okay with it, because it's a factor we can't control. What we can control are the moments we move in and out of every day. The people we interact with, the books we read, the new hobby we adopt, the additional education that we seek out and confer upon ourselves. In the grand scheme, these are the things that truly matter. Our job, if done well, is to make it easier for you to spend your valuable time focusing on these things. Plan smarter, live fuller.

When the Bloom Comes Off the Rose

By Steve DeBoth

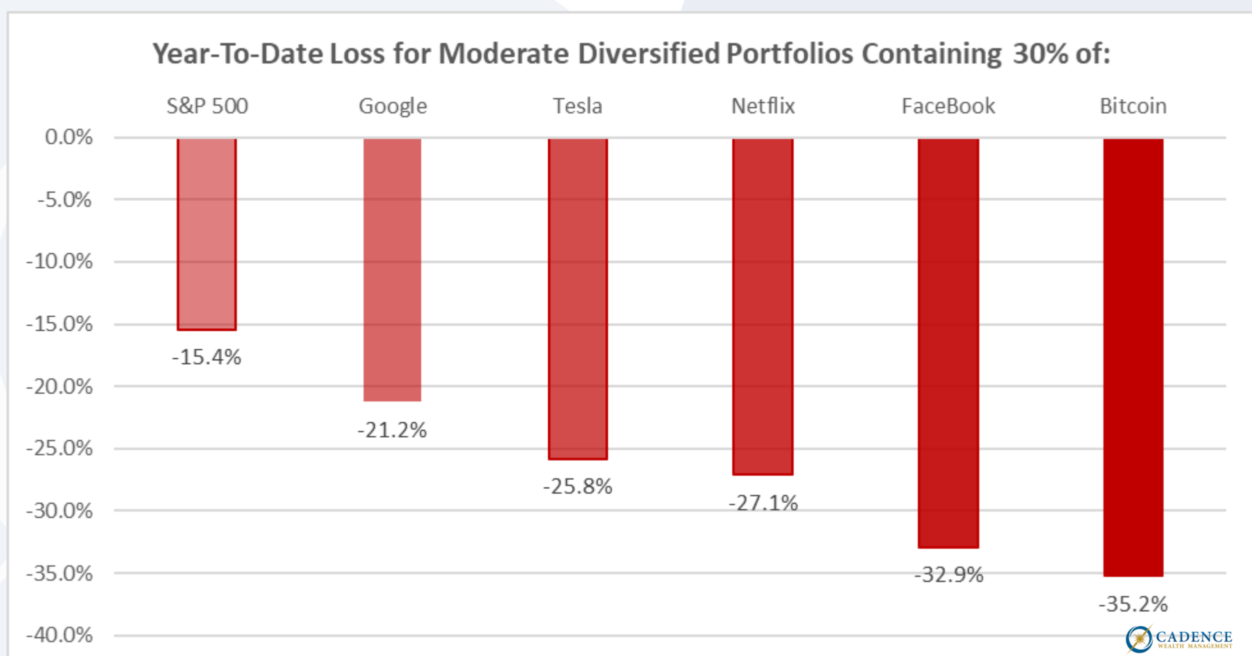
It's been difficult to miss the hype around certain investments the past few years. At different times, Alphabet (Google), Netflix, Meta (Facebook), Tesla and Bitcoin, among others, have all had their day in the sun. It sure seems like an awful lot of people have made an awful lot of money on these stocks, so it's understandable we have fielded questions from clients from time to time about whether or not they should own one or more of them. The financial news media has focused massive amounts of attention to all of them at some point. For quite a while, "FAANG" stocks which include Facebook, Google and Netflix were all it seemed anyone was talking about. In 2020, Tesla started garnering a lot of attention with its stock price rising a very undeserved 740% in that year alone. Bitcoin was right on the heels of Tesla, increasing in price between March of 2020 and February of 2021 by 780%. The hype around all of these at various points over the past four or five years cannot be understated.

But how are they doing this year? If someone had finally succumbed to any of the hype and bought any of these late last year, how would they be doing today? The vast majority of equity investments are down this year, so for comparison's sake we'll look at how these five are doing compared to the stock market in general as represented by the S&P 500:



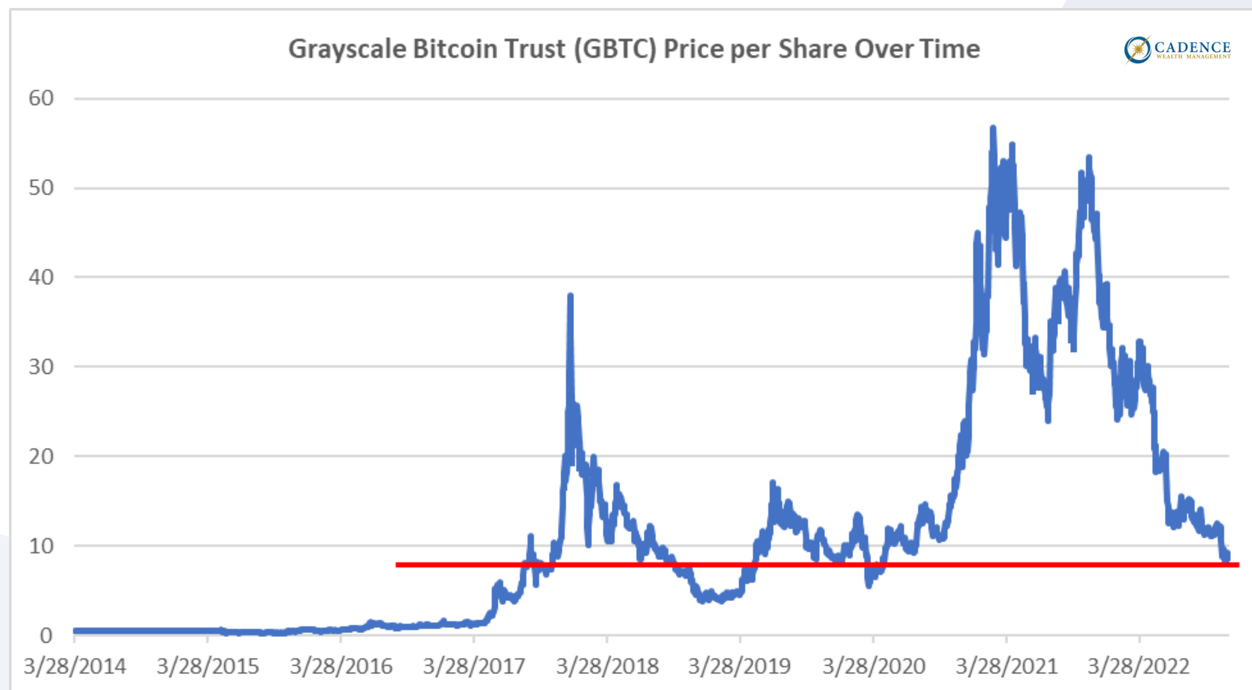
Since about this time last year, the S&P 500 is down a bit over -12%, whereas the other five investments are down between -32% on the low side and nearly -80% on the high side.

Of course very few investors would put all of their money in just one thing, so to model the impact any of these could have on an investment portfolio this year, I created a theoretical half stock, half bond portfolio where the total allocation toward large US stocks was 30% of the portfolio. As my baseline, I used the S&P 500 to get that large cap exposure. I then swapped it out for each one of the five other investments to see how much diversified portfolios containing each one of these investments would have lost this year:



It is no surprise, yet still a bit awe inspiring that changing just one investment in a diversified mix can have such an impact on your returns in a year like 2022. Volatile investments can have a place in a portfolio, and there can be strategies to buy and sell them that may shield an investor from losing more than they can afford. However, one major problem with buying investments like these is that very few people time it right. By the time they hear about them, it's already the later innings, which means they miss out on a lot of the upside but may expose themselves to all of the downside.

To illustrate this, consider the price movement over time of the Grayscale Bitcoin Trust, what I have been using as a proxy for Bitcoin in this analysis:



In order to have earned a positive return on this investment, assuming you held it until today, you would have had to purchase it on one of the days the price was below the red line and then hung on through all the violent ups and downs. When something swings so violently, it is not easy to buy it at a favorable price. What are the odds you would have either heard about it before the first massive upswing and had the confidence to buy it then, and what are the odds that had you heard about it after the first big up and down move you would have had the confidence to buy it the short spans of time the price was below the red line? The vast majority of the questions we got about Bitcoin were when the price was above the red line, if not way above the red line.

At one time or other, all of these entities mentioned above were pioneers and leaders in their industries: FaceBook with social media, Netflix with streaming entertainment, Google with search engine technology and cloud computing (among many others), and Tesla with electric vehicles. The disruption to new or established industries have allowed all of them to grow to be the 800-pound gorillas of their market segments, but eventually either increased competition or the commoditization that eventually happens with maturing industries starts to impede the ability of the market leaders to maintain their advantages. It happened with Netflix, which we covered in our February 2022 piece entitled “The Netflix Eruption”, and is in the process of happening to Tesla as we predicted in the December 2021 piece “Tesla: An Emblem of Madness”.

Though companies such as these may build their value over time and enjoy increasing stock prices as a result, once they are deemed to no longer be able to maintain their leads over their competitors, or once their market segments fall out of favor, those stock prices that rose so impressively over the span of years can come falling back to earth quite quickly. For these and other reasons, all of these companies' stock prices have fallen much further than the overall stock market this year.

Which brings us back to Bitcoin. Unlike the others, Bitcoin isn't a company, it's a currency. To be precise, a cryptocurrency, the technicalities for which are beyond the scope of this piece. The complexities of cryptocurrencies are difficult for many investors to understand, though that has not stopped them from investing in those assets. As a result, it is extremely difficult for most investors to understand the nature of the risks they are assuming when investing in an asset like Bitcoin. Within the past two weeks, a company that maintained an exchange that was used to buy and sell cryptocurrencies went from a valuation of $32 Billion to $0 and bankrupt within just a few days. As a result, the cryptocurrency market which had already lost a large amount of value this year was rocked. Bitcoin, which as of early November was already down -65% on the year lost -25% more of its value in just two days. Like Tesla and the rest, Bitcoin is the recognized 800-pound gorilla in its segment. As a result, when something bad happens anywhere in the industry, like the failure of this crypto exchange and the shockwaves that are still spreading, the biggest player isn't immune from contagion. How many people who invested in Bitcoin, including those who were receiving their paychecks in Bitcoin(!) knew about the potential risks like this? Why have so many people who do not understand cryptocurrencies invested in them? There are a variety of reasons, but in general, for many investors it is just too difficult to resist the hype.

It has not been a good year for most stocks, or most bonds, or most anything. There aren't a lot of bright spots in years like this, and even moderate stock/bond portfolios are down -15% or more, though with our use of alternatives in our clients' portfolios we are down a fair bit less than that across the board. Those investors that committed a meaningful amount of their total allocation to any of the FAANG stocks, or to Tesla, or to Bitcoin are finding themselves a lot worse off this year. We hate to say we told them so, but, well, we did. Being down -10% or less when traditional portfolios are down -15% or more should be acceptable in a year where there's almost nowhere to hide. We can all take heart, because what many people are finding out this year is that when the bloom comes off the high-flying investment rose, it is not pretty. Not pretty at all. I'll take a small loss any day compared to what that is like.

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