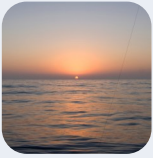




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Cadence *clips*

FOCUSED ON WHAT MATTERS MOST.

Valuation Reality – Facts Over Feelings

By Casey Clarke

Bull markets are a force of nature not so much because they take stock prices to the stratosphere, but because they take human emotion to the moon. In so doing, they almost always, necessarily, leave objective reality and the fact-based logic it demands much closer to the launch pad. Being a productive, compassionate human requires we feel things, but consistently and impulsively acting on feelings in the absence of objective logic is a recipe for disaster. Feel, think, act, in that order, with the thinking piece being as dispassionate and fact-based as one can be. Feelings will try to assassinate facts on the way to action every time.

This particular bull market is unique in that driving it are two very powerful factors; extremely large and relatively dumb passive investment flows, as well as a new era of central bank intervention and fiscal profligacy. The unintelligent passive flows are a function of indexation, which allows investors not to think about the quality of the investment they're buying. Every dollar invested in an index fund (most ETFs) sees most of its value going toward the biggest companies in the index, and since this drives the biggest (and most

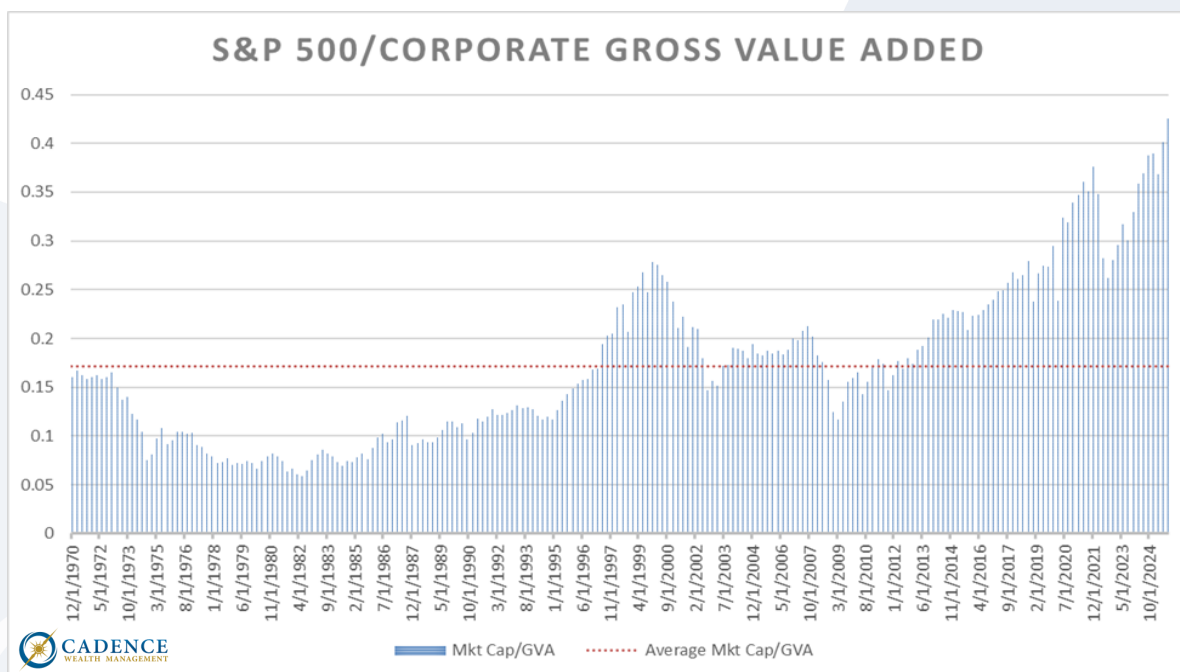
expensive) companies' stocks higher, the cycle perpetuates. The biggest index positions get most of the flows, continue to get more expensive, and thus continue to get more of the flows. This is dumb investing. But hey, you get what you pay for. Federal Reserve and government action every time the markets hiccup has served to reinforce this passive investment momentum by convincing investors that markets won't be allowed to fail going forward, so the mindset now is that every 10-20% drop will provide another buying opportunity. Investors have been conditioned for complacency like no other time in history to the point where they "feel" they can't lose. This is all taking place at a time when most investors also "feel" as though they can't afford not to take a chance on big market returns given how expensive the cost of living has become. Greed is certainly alive and well in today's markets, but there's also a sense of fear around missing out on the easy money. Both of these emotions are eclipsing any fear of getting caught up in the biggest bubble in history by most measures. And it's not that investors haven't caught wind of this bubble's existence. It's likely just a case of all this bubble talk being

an inconvenient impediment to doubling one's 401(k) balance just in time to retire comfortably or build a nice financial buffer. A classic case of facts getting taken out by emotion on the way to action.

The Facts

There are umpteen ways to measure the valuation of the stock market and get a sense as to how expensive or cheap it might be relative to a long history. The key with any of these methods is to establish a historical norm over a long period of time, complete with a diverse mix of factors that might exist in some combination today. Of course, conditions at any given point in time are unique (the whole "this time is different" idea), but typically a long enough timeframe will address the bulk of this concern in most cases. The idea is to get a sense of where we're at with common sense and logic being applied at the end of this process. We'll do that here. The three metrics we'll look at are the S&P 500 relative to Corporate Gross Value Added, the S&P 500 relative to GDP, and the Shiller Cyclically Adjusted Price to Earnings Ratio (CAPE). All three look at the stock market relative to an underlying economic baseline in an effort to get a sense as to how far ahead or behind that baseline the stock market might be.

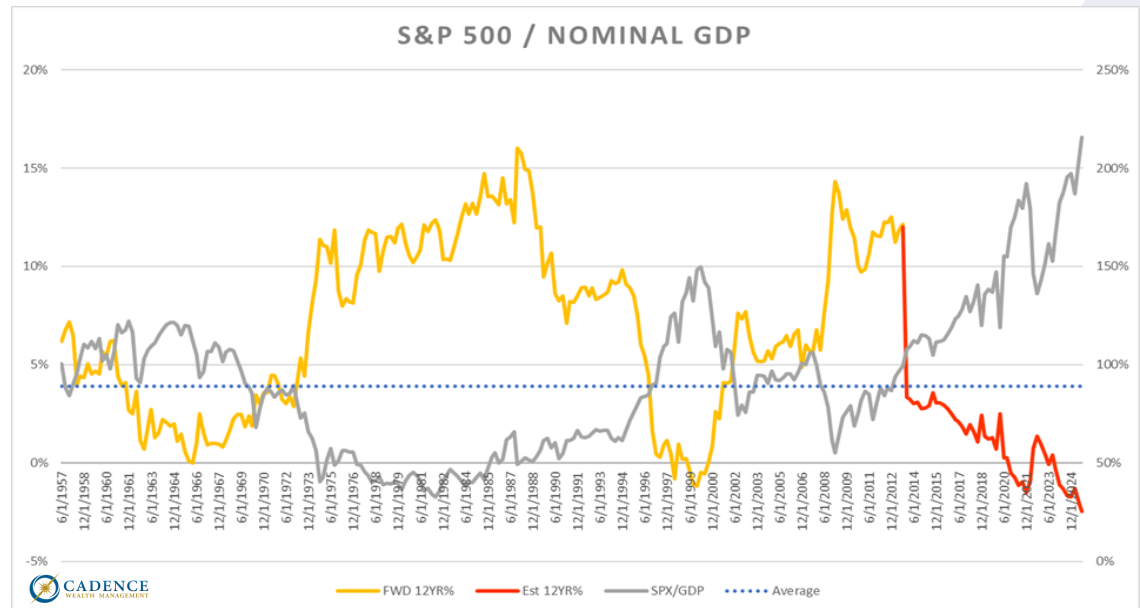
In summary fashion, the first chart, S&P 500 divided by Corporate Gross Value Added, shows us very clearly that the stock market is the most expensive it's been in the last 55 years. If the data went back further, we'd likely see that it's the most expensive ever. Tech bubble levels were superseded back in 2018, and things have gotten more extreme ever since. To get back to the 55-year average would require the market to drop -60%.



The table to the right shows how far the market would need to fall to get back to reasonable long-term returns. After a -60% drop, investors could expect to earn over 6% annually over time given a modest 4% economic growth assumption. To make money as an investor, one must buy low for the opportunity to sell high. Buying anything at record high valuations is not a winning formula over time.

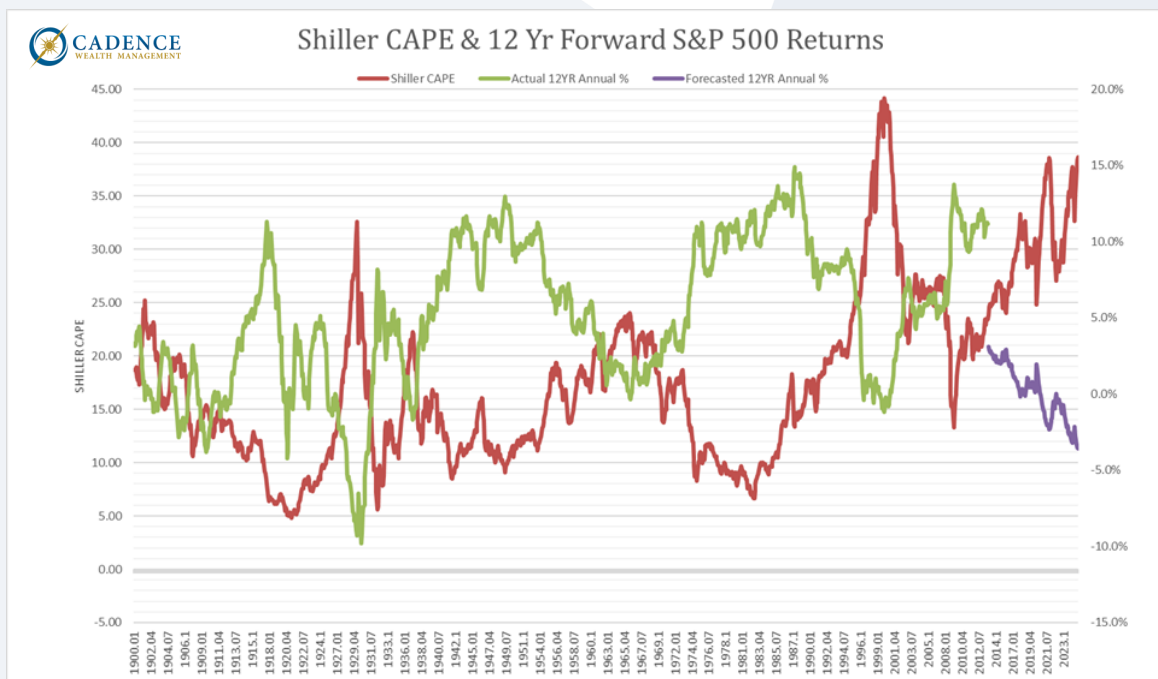
Market Loss From Here	S&P Value	Implied Annual Return Over 10 Years
From Current	6650	-3.7%
-10%	5985	-2.7%
-20%	5320	-1.4%
-30%	4655	0.0%
-40%	3990	1.6%
-50%	3325	3.7%
-60%	2660	6.2%
-70%	1995	9.7%

The next chart shows the S&P 500 divided by Nominal Gross Domestic Product (GDP) (gray line) and tells a very similar story to the prior metric. Historically expensive stocks with a -59% drop to get back to that blue dotted line that represents average or “fair” prices. The yellow and red lines represent actual and estimated 12-year returns as a result of investing at any point along the gray valuation line.



The final chart below shows the Robert Shiller CAPE ratio over 125 years (in red),

and also the 12-year returns an investor would have realized at any point along that valuation history. This measure shows a stock market more expensive than any point in history except for the 2000 Tech Bubble. The reason this one looks a little less expensive than 25 years ago is likely because of the dramatic lack of earnings that most of those high-flying technology companies had in the late 1990's. Earnings didn't matter much since technology and the internet were going to change the world. The mindset at the time was that earnings didn't matter as much as the idea; the story. Companies and investors would worry about making money later. Regardless, today's market suffers from some of this same mindset. What we can observe from more than 110 years of this history is that buying when the red line (valuations) is high leads to horrible returns over the subsequent 12 years (green line), while buying when the red line is low leads to high returns. There can be short-term periods where this isn't true, but eventually this relationship seems to rather predictably snap into form. The purple line is a calculation of where



future returns would settle out if the 100+ year relationship between valuation and returns re-aligns. Similar to the two methods already looked at, the drop to average would require stocks to fall ~61% with returns over a 12-year period being rather deeply negative.

Now What?

Like them or not, those are the facts. We can debate whether factors in the financial markets have changed to the point where valuations no longer matter, but the burden of proof is on the wishful thinker to make the case that hundreds of years of economic and financial theory is no longer relevant. We've thought a lot about this, and have settled on the thinking that things can get out of whack for extended periods of time, but ultimately settle back toward their long-running averages. Humans 100 years ago had similar wants, needs, and motivations as we do today, and the same goes for humans 500 years before that. Regardless of technological differences, human beings are the important factor in driving economic and financial conditions, arrangements, and prices.

The same way most rational people wouldn't build a home downstream of a failing dam, most investors, once educated on the matter, wouldn't be too eager to invest in stocks priced at historical extremes. Rather, they would look for investments that are priced much more attractively relative to their historical norms. Without making this piece too cumbersome, it suffices to say that the rational response to dangerous financial markets is to seek out assets for one's portfolio that provide a much more probably positive outcome over time. Of course, any investment, no matter how cheap, can go down further over the short term, but when we stretch out time, price matters. The solution to this extreme stock market can only be to lock the emotions in the basement, address the facts on the ground around what's expensive, cheap, early cycle, late cycle, etc., and take action. Our analysis has led us to favor natural resources and U.S. Treasuries at the moment, and our clients have been rewarded handsomely this year for aligning with us on that. The patience required to "leave the party early" years ago and position into more prudent asset categories has rather suddenly and explosively begun to pay off. This is typically how these things work; slowly at first, then all at once. Any solution that looks too easy usually isn't the right solution. More important to the ongoing process of investing, any solution that "feels" too easy is probably one that requires a hard second look.

Bull markets aren't just fueled by emotion, but are characterized by the domination of logic by emotion. This is true with all highly charged and emotional human activities or events. The more emotionally peaked we are, the less rational thought exists, and the more facts serve as an inconvenient impediment to the frenzy. There's a lot to unpack here... Emotion causing a disregard for facts; bad or obscured facts leading to charged emotions. It's worth reflecting on both aspects of this, and we'd argue that in order to successfully navigate the markets, as well as life, one needs to have a solid understanding of it. It ties in with conflicts of interest, financial incentives, and control, which we've written a good deal about. The point is this: We, and only we, are responsible for the decisions we make for ourselves and our families, and to make those decisions to the best of our ability, we need to be properly informed. To be properly informed, we must be objectively aware of the world around us, and to be objectively aware of the world around us, we must be dispassionately curious. To be dispassionately curious, we must think objectively, and to think objectively and rationally, we have to constantly keep one eye on the thing that can sabotage everything; the thing that drives bull markets to history-making, life-altering extremes - emotion. Facts over feelings. Cool heads, curious minds. We got this.

Even Logical Plans Can Require Patience

By Steve DeBoth

People have a tendency to want to update their long-term investment strategies every two to three years. Any time they are not earning what they feel they should, they are tempted to change their strategy. In the end, this self-deception can lead them to chasing returns without realizing that's what they are doing. It is very, very hard to get the long-term returns you want when you are chasing them in the short term.

But why do people modify what is supposed to be a long-term strategy so frequently? IF their strategy pays off right off the bat, especially if it pays off big, THEN the strategy can be stuck to, at least for a while. However, if the investment strategy doesn't seem to pay off right away, the temptation to modify the strategy becomes too great, and then returns start getting chased. When you create a long-term investment strategy based on understandable, quantifiable, and logical assumptions, you should only need to change your strategy when the assumptions change, and not based on the results of the strategy. Strategies can take time to pay off depending on what happens once they're implemented.

Consider an investor who is watching the relative moves of gold and stocks, in this case the SPDR Gold ETF – “GLD”, and the iShares S&P 500 Index ETF – “IVV”. Between 9/30/2005 and 9/30/2009, GLD was up 112% while IVV was down -6.5%. Let's use these relative moves as substitutes for historical valuations, so this investor feels like IVV is historically cheap relative to GLD, and therefore switches their holdings from GLD to IVV. This point is marked by the green vertical line in the chart on the following page.

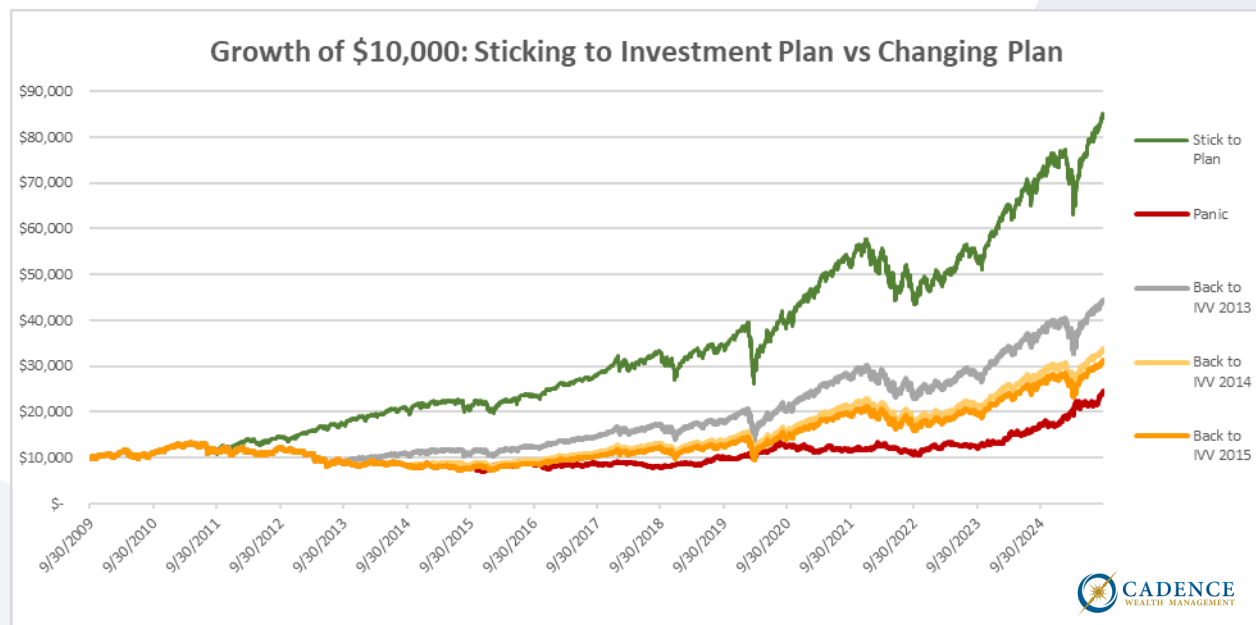
Now, let's say this investor continues watching the relative moves of these two securities and sees that, unfortunately, GLD kept increasing relative to IVV after the switch. When they first switched, GLD had outpaced IVV by 118% since the end of September 2005. However, by the end of September 2011, GLD had outpaced IVV by a whopping 234%, so the investor feels they are missing out on big earnings, panics, and switches back from GLD to IVV. This point is marked by the red vertical line.



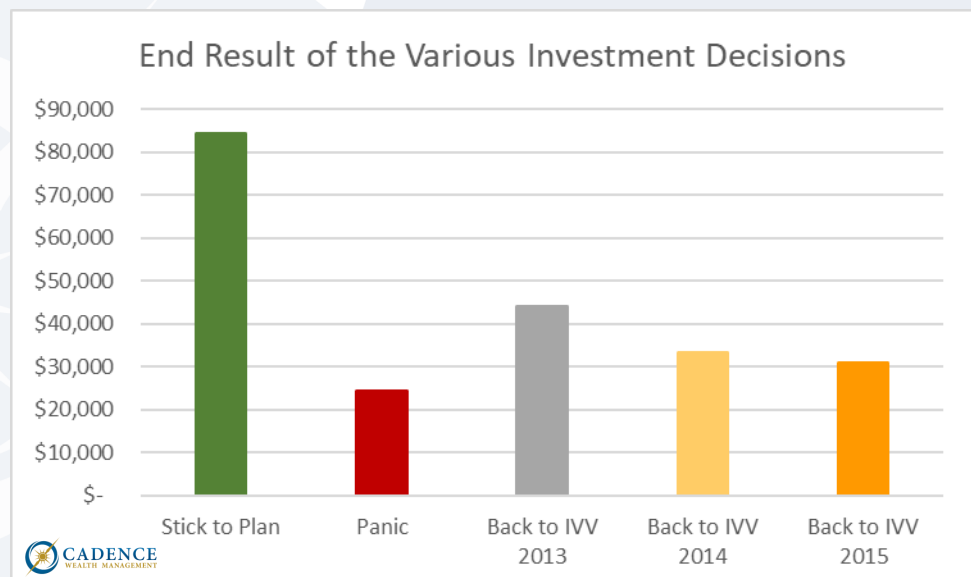
Keep in mind, IVV was historically cheap compared to GLD in 2009 at the green line. In 2011, it was even more historically cheap, so the original reason this investor switched to IVV has not changed. It may look to the investor like they're missing out, when actually their initial assessment is getting more right.

After abandoning their plan, how is this investor making decisions now? Their reasons for creating the plan in the first place never disappeared, and in fact only got stronger. Putting a different plan in place at this point will more than likely be based on GLD's price decreasing versus IVV, at which point the investor will be making decisions based on shorter term price moves and not historical valuations. Thus, they are now chasing returns.

Let's look at the effects of sticking to the original plan versus panicking, and versus panicking but then switching back to IVV in a few different years:



As you can see, sticking to the original plan (the green line), one based on understandable, quantifiable, and logical assumptions did pay off, even though it didn't look like it was working the first two years. Conversely, abandoning the plan completely and switching back to GLD for good (the red line), or switching back to GLD temporarily and then, understanding the original plan actually was a good one and switching out of GLD into IVV at various points in the future (the other lines), obviously yielded poorer returns. The differences in this case are meaningful:



This is a very simplified example of the benefits of waiting for a logical plan to come to fruition, even if it may seem like the plan isn't working at first. When conditions exist that logically point you in a certain direction, and those conditions continue, and especially if they strengthen, then it is not time to change the plan. When you decide to lighten up on US stocks because they are expensive by historical standards, does it make sense to then load back up on them after they've gotten even more expensive by historical standards? The diversified precious metal positions in Cadence's various investment portfolios have returned between 46% and 130% so far this year. In the October 2024 Cadence Clips article "The Investment Big Picture", Casey pointed out the shift that was taking place from stocks and financial assets in general into real assets like precious metals. Since that article was published, investments in Cadence's diversified precious metal and miner positions are between 28% and 90% higher than investments in the S&P 500, even though the S&P 500 outpaced those positions the last few months of 2024.

When you put a plan in place based on understandable, quantifiable, and logical assumptions, and those assumptions do not change, do not change your plan. Have patience. Our clients have benefited from our plans to pay attention to the historical relative valuations of these assets, and are reaping the benefits, especially this year.

Remembering Nick

This past month, our team experienced the sudden and heartbreaking loss of our colleague and friend, Nicholas Kraszyk. Nick was more than a trusted advisor—he was a devoted husband, a loving father to two boys, and a beloved companion to his dogs and cats. He was passionate about spending time outdoors and took pride in staying active and fit through a variety of pursuits, but above all, he treasured his family and the people around him.

Nick's passing is a reminder of how precious life is and the importance of living fully and loving deeply in each moment. As we remember him, we are inspired to slow down, appreciate today, cherish the loved ones who make life meaningful, and value the time we have together. His legacy will continue to inspire us and remain a lasting presence in the work we carry forward.



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Examples provided are for illustrative purposes only and not intended to be reflective of results you can expect to achieve.

