Michael Friedman, CFA | Chief Investment Officer

In a Nutshell

“The new normal.” “This time is different.” Both are dangerously-optimistic phrases fueled by endless positivity and rose-colored glasses. The major averages notched new highs this past year decoupled from fundamentals and the real economy, an indication we learned nothing from the late 1990s run-up and subsequent bursting of the Tech Bubble. Many correctly identified the new wave of companies leveraging the internet would fundamentally change the world we live in, only to ignore a material rule of investing, namely valuations matter. In vogue for the present decade are the cloud and electric vehicles. Both have and will continue fundamentally changing the world we live in, but that still does not make it ok to ignore valuations. The only thing “different” this time is the theme in focus. We already know the ending to this movie, as re-runs have been playing since the signing of the Buttonwood Agreement in 1792, which established securities trading and is the precursor to the New York Stock Exchange.

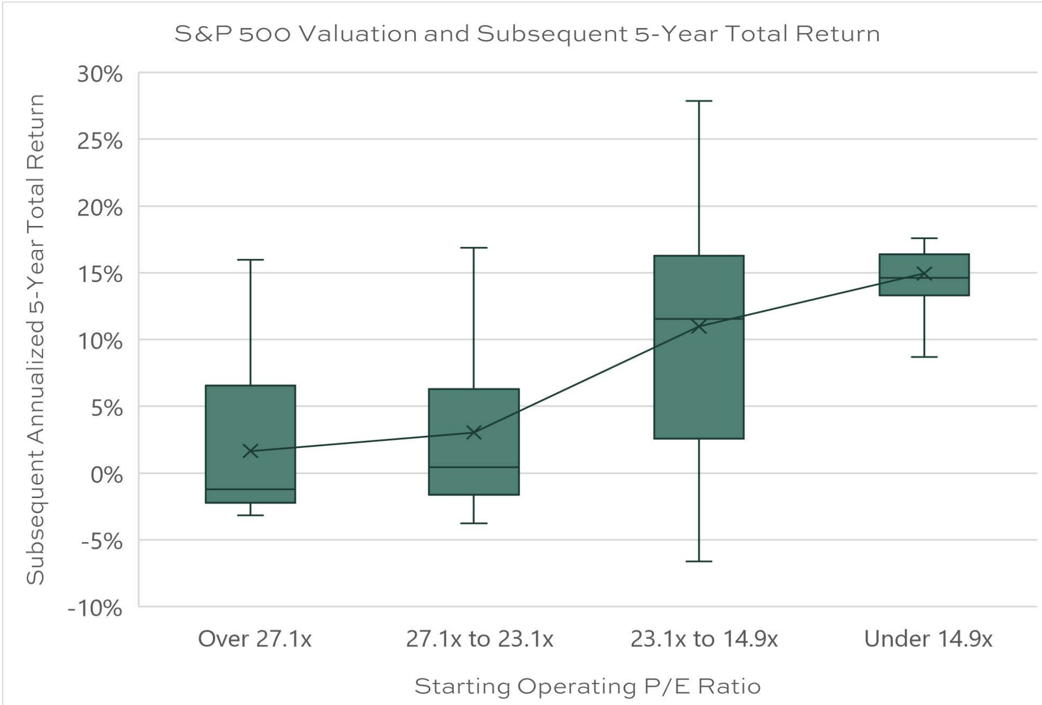
Valuations Will Matter…Eventually

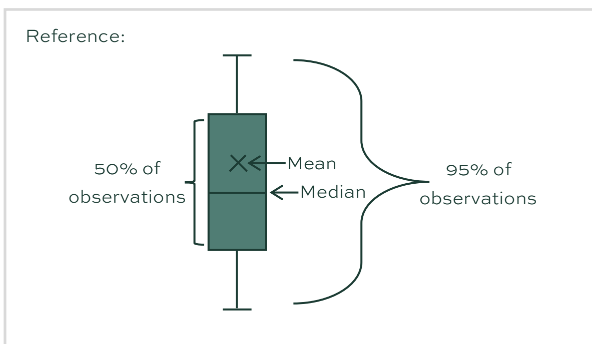
The unprecedented run in the market this past year has landed us in the nosebleed section. Of course, we are referencing the level of valuations in the stock market. We can only assume we sound like a broken record at this point, as we raised concerns of valuations at the beginning of 2020 and continued advising caution throughout the year, all while the S&P 500 returned 18.4% on a total return basis. A return that is considered excellent for any year, not just 2020, considering all the tsuris that occurred.

We need to start by explaining why valuations matter and what it could mean for future results. Valuations, in this context, refer to the trailing-twelve-months P/E ratio (P/E ratio = price/earnings) for the S&P 500. For our analysis, we looked at the starting operating P/E ratio each month and calculated the subsequent five-year return for the S&P 500 from 9/30/1989 through 12/31/2015. Operating earnings tend to provide a more meaningful result as the measure excludes one-time charges and extraordinary items not expected to repeat in the future. The selected dates start with the earliest available data and run through 12/31/2015, capturing the five-year return ending 12/31/2020. The exercise shows the five-year return realized based on beginning valuations to gain insight into what it may imply for future results.

Figure 1 groups the five-year return into four categories based on the S&P 500 starting valuation level. From left to right, the categories represent two standard deviations above average, one standard deviation above average, less than one standard deviation above or below average, and one standard deviation below average. During this period, the S&P 500 never traded more than two standard deviations below average. The line running through all the boxes connects the average return for each period. As you can see, the lower the starting P/E ratio, the higher the subsequent five-year return. When the S&P 500 P/E ratio was below 14.9, the worst five-year annualized return was 8.7%. In contrast, when the P/E ratio was above 27.1, two-thirds of the time, the five-year annualized return was negative.

Figure 1.





The meaningful relationship between P/E ratios and future returns helps set the stage for our concerns today. The Operating P/E ratio on the S&P 500 at the end of 2020 was 32.9, more than three standard deviations above the 30-year average and the highest value recorded over the period. The measure is not without company as multiple valuation metrics point to an overvalued market. The following figures address some alternative valuation measures, all of which point to irrational exuberance. The Cyclically Adjusted Price-to-Earnings (CAPE) ratio uses ten-year average earnings adjusted for inflation to provide a smoothed result by dampening the impact of large earnings swings resulting from short-term events. Legendary investor Warren Buffett's preferred valuation metric, Stock Market Capitalization-to-GDP, compares the total market capitalization for all U.S. stocks to the U.S. Gross Domestic Product. Readings above 100% indicate the stock market is overvalued and vice versa. The implication is that a country's stock market should not grow faster than the goods and services produced in that country's economy, as is implied by a ratio over 100%.

Figure 2.

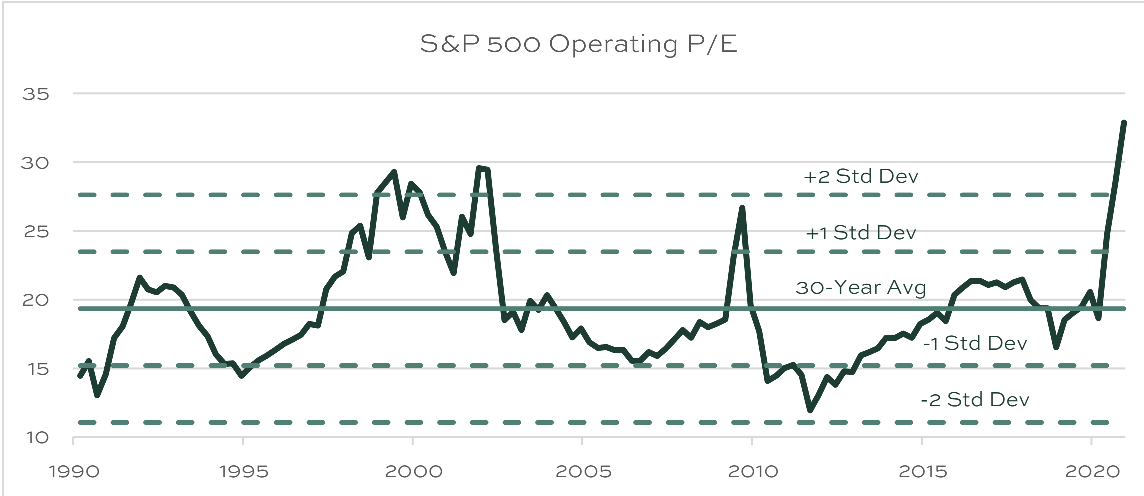


Figure 3.

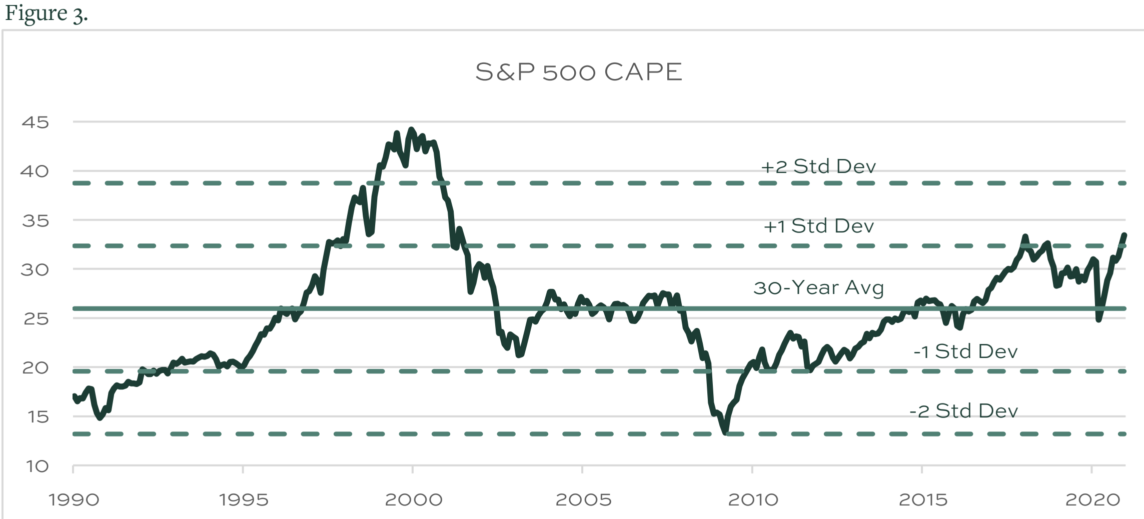
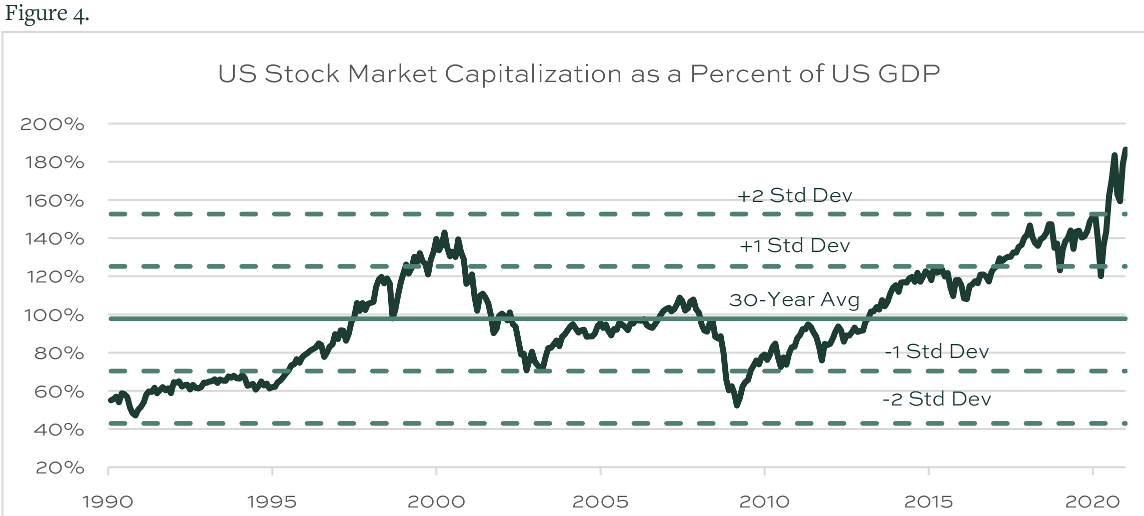


Figure 4.



The real challenge now is timing how the dynamic will play out in the market. On paper, it appears the best course of action is to eliminate exposure to the overvalued asset class; in practice, it is much more complicated. Unfortunately, assets can remain mispriced for extended periods, the thought of which keeps asset allocators like ourselves up at night. During the Tech Bubble, all three valuation measures remained elevated, above the long-term average, for years, before eventual repricing occurred. Over the four years from 10/1/1998 to 9/30/2002, the S&P 500 returned -12.9%, including reinvested dividends. Assuming we eliminated exposure to the asset class in October 1998, we would have saved clients money when the bubble finally burst. A task easier said than done. The challenge would have been asking clients for their patience as the market ran 55% to the peak in March of 2000, as there would not be any clients left to protect from the ensuing decline, wiping out all the gains and then some. Although the market is overextended today, we do not believe in swiftly exiting an asset class once it breaches a certain threshold. We know timing the market is not a viable strategy, so rather than making drastic moves, we will methodically reduce exposure as the asset class becomes more expensive, further leaning into assets with higher conviction.

The Running of the Bulls

The reason the market soared to record levels last year is there were more buyers than sellers. The simplified explanation does not speak to the specific motivating factor causing buyers to outnumber sellers; and instead, seeking to highlight the fundamental forces that make markets tick. We believe the current market environment draws interesting parallels to the second half of the 1990s. The period saw the proliferation of personal computers and internet access, in addition to the growth of online brokerages offering reduced trade commissions. Households with access to the internet grew from 18% in 1997 to 41.5% in 2000[1]. Likewise, at Charles Schwab, the share of daily trades placed online went from just over 20% in 1995 to more than 80% in 2000[1]. And, at the time, trades placed online were priced at one-fifth of broker-assisted trades. In October 2000, Schwab charged $29.95 ($45 in today's dollars) for internet-based trades, up to 1,000 shares, and $144 ($216 in today's dollars) for broker-assisted trades, up to the same share quantity[1]. These moves paved the way for new participants to enter the stock market. In 1989, 32% of U.S. households reported ownership of equity securities, and by 2001 that number stood at 53%[1]. The rapid growth in stock market participation created an environment with more buyers than sellers, adding fuel to the Tech Bubble, which burst just after the turn-of-the-century.

The lessons learned from the Tech Bubble can provide insight into where we are today. All the major online brokerages eliminated trade commissions by the start of 2020, followed by several online brokers offering the ability to trade fractional shares and many with no account minimums. Those moves are positive, further democratizing investing by making it possible for more people to participate in the stock market.

A new kid on the block we believe deserves specific mention is Robinhood, the brokerage firm popular with the under-40 crowd that gained significant traction by the end of 2019. We believe the characterization that Robinhood is playing a meaningful role in the gamification of investing is accurate[2]. The trading app is user friendly and free from clutter, making it easy for newcomers to get started. Further enticing users is the game-like experience, including animations and rewards for

[1] Bogan, Vicki. 2008. "Stock Market Participation and the Internet." *Journal of Financial and Quantitative Analysis* 191-212.
[2] Financial Times. *Robinhood faces legal action over 'gamification' of investing,* December 16, 2020.

signing up friends. With roots in Silicon Valley, users find a familiar experience to social apps, like nudges through notifications to increase engagement and encourage trading. You are more likely to engage with an app if you receive a nudge to do so. We surmise if you receive alerts regarding price movements of positions, you are more likely to act on the information by placing trades. Recent estimates peg Robinhood user accounts at 13 million. For comparison, legacy brokers Charles Schwab and TD Ameritrade had 15.1 million and 14.5 million accounts, respectively, at the end of 2020[3]. Although Robinhood users have a much smaller average account size than the legacy brokers mentioned, we believe if you have 13 million people receiving notifications about their portfolios and acting on that information, it can have a meaningful impact on the market.

Early in 2020, the coronavirus spread halted entertainment, travel, and leisure activity while confining people to their homes. Easily accessible at home and not shut down, the stock market was a shoo-in. Individuals with cash on the sidelines, earmarked for activities canceled indefinitely, could now put those funds to work in the stock market. Others, looking for alternatives to casino gambling and sports betting, discovered stock options and how to use them speculatively to bet on stock price changes. Additionally, Robinhood has brought the stock market to a new cohort of investors, as previously mentioned.

As markets went haywire in the first quarter of 2020, Charles Schwab, TD Ameritrade, and E-Trade experienced new account quarter-over-quarter growth of 58%, 149%, and 169%, respectively[4]. For the full-year, JMP Securities estimates individual investors opened more than 10 million new brokerage accounts, a record-breaking year for the industry[5]. Simply put, the addition of new market participants, along with the infusion of cash previously on the sidelines, created an environment with more buyers than sellers. The dynamic enabled the market to soar to new highs even though uncertainty was through the roof and corporate profits on the decline.

We believe the market can continue higher but would not be surprised to see a pullback at any point as the euphoria cannot last forever. With most activities still shut down and more stimulus on the horizon, it is hard to argue for much of anything but what has been the status quo for the market during the past nine months. A broad market repricing could occur at any time, without warning; it is all but impossible to predict what will cause the sentiment to change. 20-years after the Tech Bubble burst, we still do not have a good explanation why March 2000 was the market peak, although news that Japan had entered a recession causing concerns of a global slowdown is the leading contender.

In no particular order, a few events we see as potential triggers for a market repricing today include: the economy reopening, causing investors to turn their attention elsewhere; or perhaps traders are waiting for their short-term capital gains to transition to long-term capital gains, to cash out at the more favorable long-term rate; maybe an unexpected increase in interest rates spooks investors that cheap money is not here to last; but most likely, it will stem from an unforeseeable event, or investors just waking up on the wrong side of the bed deciding today is the day.

---

[3] CNBC. *Schwab earnings top estimates in first report since TD Ameritrade merger, accounts near 30 million,* January 19, 2021.
[4] CNBC. *Young investors pile into stocks, seeing 'generational-buying moment' instead of risk,* May 12, 2020.
[5] The Wall Street Journal. *New Army of Individual Investors Flexes Its Muscle,* December 30, 2020.

Approaching the Summit

Portfolio positioning in the current market environment is challenging and requires patience. Valuations are concerning, and while we are not jumping up and down yelling from the mountaintops yet, we are most certainly approaching the summit. There is truly no place to hide as stocks and bonds are expensive while cash cannot keep up with inflation. We are, for lack of a better phrase, trying to choose the best of the worst. We attempt to find the cheapest subset within a particular asset class. We are currently underweight stocks and bonds and overweight alternatives through a hedged equity strategy designed to limit downside exposure at the expense of an upside cap. Even in our high-octane opportunistic equity strategy, we are currently carrying about 15% in cash as we struggle to find another home for it. In our multi-asset portfolio strategies, we continue to reduce our allocation to U.S. large-cap stocks and the growth style while tilting towards value and a meaningful overweight to international, namely emerging markets stocks. Should the market continue marching higher, we will further lean into those themes. Most important of all is remaining invested and not making any rash moves by maintaining a diversified portfolio built for whatever comes next.

Figure 1. Chart represents the operating P/E ratios on the last day of the month from 9/30/1989 to 12/31/2015. The corresponding annualized 5-year total return was calculated starting from the last day of each month during the period. The intersection of the two data points is plotted on the chart, grouped by category based on starting operating P/E ratio, to visualize the annualized 5-year total return historically associated with various operating P/E ratios to start the period. **Figure 2.** Chart represents the period from 1/1/1990 to 12/31/2020. **Figure 3.** Chart represents the period from 1/1/1990 to 12/31/2020. **Figure 4** Chart represents the period from 1/1/1990 to 12/31/2020.

S&P 500: Measures the performance of U.S. large-cap equities and is comprised of 500 companies across sectors and covers approximately 80% of available market capitalization.

Sources: CNBC, Financial Times, Journal of Financial and Quantitative Analysis, S&P Dow Jones Indices, The Wall Street Journal, YCharts.