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INVESTMENT MANAGEMENT

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Equity Market Commentary

APPLIED EQUITY ADVISORS TEAM | SLIMMON'S TAKE | APRIL 2024

The following views and perspectives are formed by the work of the Applied Equity Advisors team in managing assets for investors.

AUTHOR

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1. I distinctly remember a day in my rookie Wall Street year in late-1986, when another newbie said to me (as we stood over the Quotron machine), "rumor has it that Mike Milken (the "junk bond king") is going to take home $10 million in compensation this year".

   We agreed that was just an outlandish rumor.

   Turns out, we were extraordinarily low, but that's not the point.

   While $10 million seems like nothing in today's dollars, no one needs a tutorial about the powers of inflation over a long period of time to understand that $10 million seemed unfathomable back then.

   That's certainly not the case today.

   We all know how inflation degrades the value of assets over time.

   BUT ARE OUR CURRENT INVESTMENTS (collectively) CONSISTENT WITH THIS KNOWLEDGE?

   Consider the following:

   Hypothetically, here is how Mr. Milken's $10 million could have accrued as an investment *after inflation* over the past 37 years, had he made the following asset choices:[1]

   a. 3-month Treasuries (surrogate for a money market): $10.4 million
   b. Intermediate corporate bonds: $54.6 million
   c. S&P 500 index: $153.8 million

[1] https://pages.stern.nyu.edu/~adamodar/New_Home_Page/data.html. Nominal annual returns are adjusted for inflation for each year going back to 1987. Cumulative returns are calculated based on yearly real rate of return which adjusts for inflation for the corresponding year.

The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.**

2. I am confident these results do not shock anyone. Buying stocks can be a big money maker over time… while keeping the cash liquid barely beats inflation.

   Yet if we all know the results:

   WHY ARE WE CURRENTLY ACTING SO DIFFERENTLY?

   *As of April 3rd, total money market fund assets had swelled to **$6.1 trillion**. That's the greatest growth in **any asset class over the past year**, up almost $1 trillion.*[2]

3. So why are investors collectively pouring so much money into the money market when we all know that inflation is the money market killer?

   If we know so much about the powers of inflation, why are we acting so irrationally NOW?

   I think there are two reasons:

   a. Classic anchoring bias:

      "*We interpret new information from the reference point of our anchor.*"[3]

      Money market yields *do* look attractive at 5% because we are anchored to the reference point of them yielding less than 0.5% just two years ago.

      But the flaw in that logic goes back to inflation.

      Inflation is running 3x higher today than it was two years ago.[4]

      Inflation is still the money market killer as BOTH are higher, not just the yield.

   b. Uncertainty about the future:

      One of my favorite behavioral finance gurus, Morgan Housel, says:

      > *The past was not as good as you remember, the present is not as bad as you think, and **the future will be better than you anticipate.***
      >
      > *Optimism is very hard to imagine in the future even if you understand how powerful it was in the past.*[5]

      While equities would have been the right investment back in late-1986, I promise you the future was just as murky then as it is today.

      Yet, at every event I have spoken at *this year*, the first two questions have consistently been about *geopolitics* and *the deficit*.

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[2] Strategas. April 23rd, 2024.
[3] TheDecisionLab.com.
[4] Bloomberg.
[5] The Morgan Housel Podcast. March 8th. 2024.

Negative and more negatives.

But let me caveat that, *those have also been the first questions at almost every investor forum where I have spoken going back 20+ years*.

I have yet to be asked:

> "So, Andrew, how will AI make me far more productive in the future than I am today?"

Or

> "When do you see the new diabetes drugs making inroads into the horrible ravages of Alzheimer's and Parkinson's?"

I don't take lightly our budget issues or the two wars that exist.

However, technology and scientific advancement have never been more exciting than they are today, in my opinion.

Yet why are we collectively pouring more money into an inflation ravaged asset than ever before?

It's simply due to what Morgan Housel says. *Optimism is hard to imagine when we look to the future.*

The perceptions that yields are more attractive today *and* the world is more uncertain today, as compared to the past, have drawn these unprecedented flows.

4. On my way to work recently, I listened to an interview with a billionaire former hedge fund guy who now runs his family office.

   He spent the first five minutes railing on US politics, the Presidential candidates, and the lack of fiscal discipline.

   The interview scared the daylights out of most listeners, I am sure.

   Yet only when the interviewer drilled down did he concede that he was *fully* invested in equities and distressed bonds.

   So typical.

5. Now let's get a little more granular on equity returns for 2024.

   Investors tend to think in terms of calendar year returns largely because people assess their portfolio results that way.

   From here, what can we expect equities to return through year-end? In other words, where will the market end the year?

   I think there are two numbers that will assist in answering that question.

   $277 and **20**.

First, **$277**:

That's the bottom-up consensus Factset earnings estimate for 2025 for the S&P.

Consider, the market generally prices off future earnings, generally for the next 12 months.

If we fast forward to December 31st, 2024, the next 12 months will then be the 2025 eps estimate which is currently **$277**.[6]

Second, **20**:

That is the current P/E multiple on next 12 months earnings (which currently is part-2024/part-2025).[7]

Hence, two simple questions to ask:

a. *Will the **$277** move up or down between now and year-end?*

   What I can tell you is that since the beginning of the year, the 2025 earnings estimate number has gone UP by $2.00, certainly a positive sign….

   And I have not seen enough Q1 disappointments in this reporting season to expect that increase to reverse.

   Yes, earnings misses capture the headlines, but overall I am encouraged by company results.

b. *Will the S&P trade at its current **20x** at year-end?*

   In my career, I have seen P/Es higher and P/Es lower than they are today.

   However, I dispute the notion that P/E multiples being above long-term averages is a reason for caution.

   Over the past three years, the average ROE (return on equity) for the S&P 500 is 19.2%. By comparison, in the 1990s the average ROE was 14.2%, in the 2000s it was 14.3%, and in 2010s it was 15.2%.[8]

   As an analogy, if you were interested in buying farming acreage, wouldn't you be willing to pay a higher price for a plot of land with a higher yield than you would for a plot of the same size that produced less output?

   Companies in the S&P today are producing a higher return than in the past, seems we should be more willing to pay for that.

6. As it pertains to Applied Equity Advisors strategies, quarterly earnings reports can cause volatility in stocks in unexpected and sometimes baffling ways.

   Yet longer-term, if stock prices generally represent the present value of future expectations, did future expectations go up, or down, post-eps report?

   That's what we try to focus on.

[6] Factset as of April 19th, 2024.
[7] Bloomberg as of April 19th, 2024.
[8] Factset. Average S&P 500 calculated based on "earnings weighting" of each individual company in the S&P 500.

What we have experienced so far is a few negative stock reactions, while future expectations went *up*.

That has created some attractive stock opportunities for us currently.

Andrew

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