FRIDAY, FEBRUARY 9, 2024

Well, hello and welcome to another edition of Dividend Cafe. I'm joining you from our New York office today, although I am heading out tomorrow with my wife for Florida. I'm going to be in a different city in Florida each day of next week, then returning to New York for the weekend, then heading down to our Nashville office where I'll be for a week before heading back to our California office where I'll also be going to our Arizona office for a day. And there's a lot of speeches I'm giving in between and different things going on. But thankfully for me, my wife is coming with me in all these destinations. There's a lot of things going on. A lot of members of our team I'm going to be seeing, a lot, a lot, a lot, a lot of clients I'm going to see, which is my favorite part of the job. A lot of the things going on in the midst of earnings season right now, a couple portfolio changes that we've been dealing with that we've already either done or one in particular right now that I'm still deeply considering with my co-CIO, Brian, in the midst of a pivot around Fed expectations. You may have heard there's a lot of geopolitical things happening. I mean, there's just a lot going on.

And I'm fond of saying that that's not unique. That's unique is when there isn't a lot going on because that's the truth. I've done this a long time. And a hyper level of activity is the norm. It is not, it's the rule, not the exception.

Right now I also am kind of celebrating, but also just doing a lot of work around the release of my new book, which is on the subject of work. And so the first part of Dividend Cafe today, I have three different subjects that are not really all that

correlated with one another. So I guess you're getting three for the price of one, which is really the same price as when you get one for the price of one.

The first thing I want to address is a question that came to me about why I wrote a book on the subject of work when my profession is finance and investing. And I think it's a really important question. I'll put it this way. I think it's a really important answer. The question is very fair though, because the book admittedly does go into certain categories that are definitely things I'm passionate about. I like to think they're things I know something about. I had a certain upbringing that gave me a little head start and some of the elements of the more philosophical or theological parts of the book.

I wouldn't want to be tasked with doing exegesis for my profession, but I suppose some of the exegetical work in the book is work I would proudly stand behind. But yeah, I mean, I do economics and we do financial opportunity within an economic context. That's my job and it involves doing this on behalf of clients. And so it's fair to say there's certain elements of a book about work that can be kind of out outside of those lines. And the thing I want to reinforce for people listening is an economic concept that I really actually believe, as well as I'm able to succinctly say it, is the synopsis of economics.

I believe that work is the verb of economics. It's an expression I'm almost sure I made up myself. I don't remember stealing that one from anyone else when I was designing a course in

economics for high school students that I taught that I started teaching a few years ago.

And what I mean by this is that I start with the basic premise that economics is about human activity, both an individual and social context, what humans do individually and what they do collectively cooperatively towards certain aims that impact others, families and communities. Around the scarcity problem, around their need to allocate resources that are themselves scarce, meaning not infinite. If all resources were infinite, I don't think such a thing as economics exists. It's also somewhat metaphysically impossible for us to comprehend what a world with unlimited resources looks like. But be that as it may, that isn't the world we have and that's really what economics is about. There's a sort of social science that comes out of the allocation of scarcity. And what has happened over the years is that in the process of one, doing things to provide and doing things to make better, to enable a better quality of life, and it is also true that that is being done on behalf of oneself and generally throughout the history of civilization for one's family, that there is this thing that takes place called economic activity, the production of goods and services that then enables people to get a better quality of life by creating a better quality of life for others. One is producing goods and services that others are better to buy and in so doing it betters their own situation. And this really is, in my opinion, what economics is all about. Now it got much more complicated and frankly it got much more beautiful, much more glorious. Over the years, post-Enlightenment, the concept of a division of labor, the greater

embrace, particularly in the western world of private property, of rule of law, there are elements that come in and substantively change the game for the better in terms of this whole process. But fundamentally, you're talking about economics as this action of allocating scarcity and doing so through means of production and then that involves having to respond to consumer choice, it involves risk-taking. But one of the things that then becomes extremely pertinent to my day job is that this allocation and this production requires capital and that there are people who will invest capital into the debt or equity of a productive activity for the purpose of them receiving a return on investment that enhances their quality of life. And the capital that they put in enhanced the quality of life of the producer of the good and service involved and the recipient of the good and service involved.

There can be losses because the system doesn't work, there are no profits if there isn't the fear of loss, so risk-taking is a part of it and this is sort of the crux on which all financial or investment activity comes.

Every single thing I just said, if you were to rewind the tape right now and go sentence by sentence, involves work, the decision-making, the adjudication about allocation, the calculation, the investor to go do the calculation to determine a risk-reward trade-off, an advisor bringing in economic or investment opportunity, somebody putting a shovel in the ground to build the economic opportunity. I mean you can unpack this in so many ways, it's about work, work, work, work, work, that drives

everything I just said. And so this is what I mean by work being the verb of economics. To the extent that we have investors that are investing in a project, a company, an equity, or a debt particularity, they are investing in someone's work.

And work being the verb of economics is a universal statement around all of this. I believe that it is, well yeah, my book definitely gets into the God-given dignity of work, it gets into the way in which work is our purpose, our purpose, our purpose, our purpose, our that it honors the human person. But there is all at once a worker, a person benefiting from the work, and investors investing in this process. There are a number of stakeholders all around it. And I do think that it is very important for investors to remember that what can seem to be tangential around free enterprise, around even kind of a theological message of work, that it is intrinsically connected to the very process of investing, and it colors the entire way we think about risk and reward at the Bahnsen Group. So that's my answer to that question. Okay, the second thing I want to address this week, I'm thinking more and more about modern portfolio theory because I am just becoming unglued to some degree around this idea that modern portfolio theory, I'm becoming unglued around this idea that modern portfolio theory and a 60-40 portfolio are synonymous.

And I don't know where this came from. Now first of all, what is modern portfolio theory? Harry Markowitz won a Nobel Prize, he won an essay in 1952. It is a brilliant theory, but it doesn't say anything about 60-40. It merely alludes to the kind of incontestable fact that investors are risk averse and that an

optimal portfolio is one that factors in the risk adjustment. And he's defining this in the context of what we call mean variance. You know, a mean is an average, variance is variance, up and down movement. How much volatility around an average return there is. So all things being equal, all Markowitz said was if two portfolios return the same thing and one does so with less risk than the other, that's the portfolio investor will want. I believe this stuff is rather tautologically true. So therefore the question is applying modern portfolio theory because it looks at historical rates of return of asset classes. It looks at historical mean variances or volatilities of asset classes. And then from there it tries to extract an optimal portfolio given a particular investor's situation. And I think that aspiration is all perfectly fine. Whether one knows they're doing MPT, modern portfolio theory or not, is irrelevant. That's all you're trying to do is optimize a blend of risk and reward across multiple asset classes to achieve an optimal total portfolio on behalf of a given investor.

I guess 60-40 got ascribed to this because one realized that there is in a 60-40 portfolio a 60 asset class stock and a 40 asset class bonds and one asset class performs better than the other but blended together it may create a more optimal return because of the reduced volatility.

And I think that's all perfectly legitimate and obviously historically it's incontestable. Even critics of a 60-40 portfolio like me are well aware that that is empirically true that a 60-40 portfolio achieved a better risk adjusted result over 30, 50, 70, 100 years than a 100% stock portfolio did. A better risk adjusted

portfolio. I don't understand is why first of all we're limiting ourselves to two asset classes within that. Why we presuppose that anything that was just said tells us what to do with the portion that's being invested into equity. It doesn't say anything about the composition of equity, active versus passive, 500 stocks versus 30 stocks, dividend growth versus big tech. There's all sorts of other decisions that could fit within that that modern portfolio theory doesn't speak to at all.

But it is the basic premise of implementing non-correlated asset classes with one another that one can turn the knobs of optimal risk reward tradeoffs to get an optimal portfolio. That is the basic concept by which I came to believe in implementing alternatives into a client portfolio. That one could essentially use a different lever to reduce some of the volatilities that go into a total return result in the end.

The problem with it has always been, I've written about this so much, you can't just throw the word alternatives in and get an outcome. You can't back test the beta of some word called alternatives. You can back test an index of a bond portfolio or an index of a stock portfolio.

There's real historical returns, but with alternatives it means by definition a gazillion different things. It is inerrant in the term that it is idiosyncratic.

Therefore it comes down to a certain selection. It could be hedge funds, private equity, real estate, global macro, private credit, all

of the different components that make up the alternative investing space.

Implementing them efficiently in a portfolio may very well reduce some of the mean variance in the portfolio and it may enhance the total risk adjusted return, but even that outcome is unknown just as the beta of an asset class's future is unknown. Rather than relying on history of an asset class in one adjudication, you're relying on manager selection, execution, due diligence. It's an active process.

The future is uncertain that way. I think the principles of modern portfolio theory are enhanced by the way in which we approach the portfolio construction process that seeks to be extremely active in dividend growth focused in equity and that seeks to implement alternatives to buffer some of the overall portfolio characteristics. Finally, I've talked a lot lately, I re-placed some links in Dividend Cafe today, about the precedent of some elements of what we're seeing now to 1999, the end of the tech boom, the end of the dot com boom, and that sort of societal insanity that resulted in a lot of really difficult things. It did not merely result in the implosion of the pets dot coms of the world, it resulted also in the highest quality of companies dropping in some cases 90, 95 percent. A few of those fast forward 25 years are up huge.

The lion's share of them are gone altogether, especially the low quality ones. People will ask me, what is the commonality between right now and 1999? I'll say, look, there's sky high

valuations. You see some of the Super Bowl commercial celebrity advertisements, some of the pop culture concerns that are very candidly never really good. And then the differences.

There's no question the things that are massively expensive right now have way better cash flows and profits than the things that were real expensive in 1999. That's a huge difference.

But when it comes to the valuation side and when it comes to the representation in the economy, the percentage of market cap, the fact that the S&P could be up 25 percent last year with 72 percent of its companies up less than the index itself was. The top heaviness, the yes, the sentiment. There are a number of things that are very 1999 ish, but none of that's helpful because in 1999 you did not know that March of 2000 was going to come. And until March of 2000 came, even one who knew it was going to come didn't know if it would be April or October or 2001 or 2002.

That's the whole issue is that bubbles bursting are things you can only talk about in hindsight.

They're untimeable, unknowable by definition. So one has to make various decisions about their investment philosophy in advance of it. I don't know exactly how a lot of the things with the current Magnificent Seven or FAANG or Big Tech go.

I do believe it's a plausible theory that the most bullish case that which escapes a sort of significant drop off is still one that isn't very attractive, which is this choppiness I've talked about, which is basically what's kind of happened for all but one or two of the names of Magnificent Seven is that you go, well, they're up so much last year, but then you look at the return in 2022 and combine the two and you're like, oh, maybe not. Some are, some aren't. But you know, if you look at the annual compounded returns now going two and a half, three years on a few of these names, it's very quite underwhelming and we'll see where that goes from here.

I'm going to provide some math for you next week. I have one of our analysts confirming some work I did this morning on one valuation metric, but until I confirm I'm right, I don't want to tell you what it is. So we're doing a little more. I always, you know, do some work to make sure I validated the analysis. But my point is this, OK, history doesn't always repeat, but it rhymes all these cliches. I am not calling twenty twenty four, nineteen ninety nine or twenty twenty three ninety nine. I'm not calling twenty four, two thousand. There are certain similarities in artificial intelligence to some of the Internet boom. But my point is that history ought to be a teacher to the extent that we can let it be. But it isn't a perfect guide. And I still believe that the future belongs to those who learn from the lessons of history.

All right. Three lessons for the price of one. Check out dividendcafe.com for the chart of the week and more. I'm going to leave it there. Please send any and all questions you have to

questions@thebahnsengroup.com. Pretty likely next week's Dividend Cafe will be an additional treatment of a lot of your questions. I think we've gotten a few that have backed up. There may be a single topic that comes in that inspires me. And I put that questions off a week. But I will be bringing you Dividend Cafe from Florida next week before I come back to New York. And I look forward to it. Reach out anytime and thank you for listening and watching and reading the Dividend Cafe.

Due to the publishing time constraints for us to produce our daily missive, podcast, and video, the best we can offer at this time is a machine-generated transcription which contains errors. We will continue to work to improve this service and appreciate your patience with us.