FRIDAY, AUGUST 2, 2024

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.

Hello and welcome to the Dividend Cafe. This is an exciting week in markets and really played into what I was already planning to write about this week in the Dividend Cafe. I am recording in the middle of the market day on Friday, and I really can't speak to what will happen in the last few hours of trading here.

As of this moment, we are down 1600 points in the Dow in the last 48 hours, which is about 3. 9%. The NASDAQ is down 6 percent in the last two days. And it is down over 10 percent in the last three weeks. So you've seen a lot of volatility and in the last couple of days to the downside in some of these market barometers, the most intense of course, as in the tech and NASDAQ side, but it's really, especially in the last couple of days, become an issue across the whole market.

And there is a question. About, this Dividend Cafe is not about what's happened in the market the last two days. I happen to think a lot of this stuff coincides that the broader point I want to now talk to you about is connected to what's happening in markets. I basically know it is, but I'm not talking about it because it just so happens that the markets are in a volatile time or that there's been a bit of a rotation or there's been a bit of a repricing.

July was actually a fantastic month. For a lot of aspects of the markets at certain sectors, certain areas that we happen to care about a great deal. August just started off first couple of days with all this volatility, but it has not been equally distributed volatility, but those things are irrelevant.

In terms of what would motivate me to write or structure a Dividend Cafe around. I want to talk about valuation. And I want to talk about the role of price and how it interacts with value for investors. And I think that subject is relevant to what is likely happening in markets at the moment.

But it's a tricky subject because when we talk about value, we are having to do so based on a certain view of the future. And views of the future are extremely fallible. And that goes for smartest among us or the most arrogant among us. There is a significant challenge in anything that requires.

Forethought into the future. But one of the things I want to argue today is often times in the world of high valuation high growth investing It does not really come down to being right or wrong about the future That it is actually a byproduct of a state of mind About the present and that state of mind is often deeply flawed So in terms of what we want to start off staying just as a kind of rule of thumb to consider I the idea of saying To buy things that are overvalued is not good and to buy things that are undervalued is good as it is.

That sounds like a routine, obvious, acceptable thing to say. Yet I would also be very happy to say that as earnings go, so goes the market, that fundamentals matter, that when. Fundamental conditions are deteriorating. That's usually going to be negative for a stock price and that when business conditions are improving, that's usually going to be a good, and a lot of the very high growth, high valuation companies that I happen to think are most vulnerable, have very strong business fundamentals.

So how do I reconcile these two things? How can I say as earnings go as fundamentals go, so go a risk asset pricing, and at the same time be concerned about the relationship between price and value of a given

investment. I'm going to read directly from Dividend Cafe here today, but I'm reading my own words.

Sometimes the expectations of a company doing well can be pre priced in, or overly priced in, and then the future performance of the company may very well have to do with its stock price, but it has to do with the stock price that was already set, not the one that is to be. In other words, The stock price may very well reflect valuation, excuse me, fundamentals, but if the valuation is too high, then that's irrelevant for the future.

It reflects a past stock. And this is a very difficult arena because one doesn't know in the present what that means always for the future. And I want to suggest today three rules of thumb that I think help simplify this discussion a great deal. There are companies that complicate. This basic worldview that one should not be buying something today that has great prospects for tomorrow.

If the price today already reflects the prospects for tomorrow, which by the way, if I had just said that a few minutes ago, I might've saved you all the two minutes of having me get to this point. That's my basic summary of what I'm saying is you can have great prospects for tomorrow, but the price reflecting it today makes it less compelling.

Because those prospects for tomorrow already priced in simple enough. The challenge is that there are absolutely companies that have wildly high valuations based on wildly optimistic prospects for the future. And then as the future comes, it turns out those prospects ended up being even better than expected.

And so you think back to when 600 billion company, it was massive. It was unfathomable. And the projections for what was happening in these first three, four, this is like the first year of the iPhone. This is the

third, fourth, fifth year. People already knew it was big and they already knew it was going to be even bigger.

And it turned out that valuation proved to be far too low over time. But there is a real big danger in looking at some of those cases and applying them to all sorts of future scenarios. And again, I think there's a kind of three pronged test that we want to look at that will be useful. We are price conscious at the Bonson Group.

We are fundamentalists. We care about the fundamentals of a business and we care about the price around those fundamentals. But worrying about the future fundamental opportunity and whether or not it's reflected in the valuation, this is predicting the future. And I want to come back to that in a moment.

Let's take a moment, just understand in the present market environment, one of the reasons. That I have a bit more nuanced view that allows for a Darwinian interpretation of what will be in the market. And I appeal a lot to the testimony of history out of the NASDAQ boom in in 2000 is, first of all, the overall market.

Valuation level. There's a chart at divinity cafe. com. I'm not sure if they're able to put it up on the video right now for you or not. If not, just go to divinity cafe. com and look at it. But it really is showing that we're not just talking about a high PE. I talk a lot about a high price to earnings ratio.

We are talking about that and we are talking about that forward PE and backward PE, and we are talking about also a high price to book value, a high price to sales, a high enterprise value to sales, a high enterprise value to EBITDA. There are all sorts of valuation metrics that I look at religiously, and they're all in the very far extreme of historical valuations across the S& P 500, that is.

Now, Trailing versus forward earnings. One of the reasons you have to look at both is in theory, one could have a very high multiple on trailing earnings, but not a high multiple forward. If the growth of the earnings year over year is going to be dramatic. But what I just want to be clear, we are already assuming dramatic earnings growth in 2025 versus 2024, about 11 to 13 percent growth.

And with that assumption, We are trading at 21 times earnings. Okay, let's just call it a 25 percent premium to historical valuations. And so when you look at, and this is where the second chart in DividendCafe. com becomes very important today. When you look at the S& P itself and ignore the other sectors, it's about 26 percent above its own historical valuation.

It's pretty high, but that does not mean it's dropping 26%. The earnings themselves can come higher. The valuation level itself could reset at a higher level. The historical average could move through history. The ability to stay overvalued for a bit could be sustained. There's all sorts of things that make this a bad timing mechanism and whatnot, but I'm just simply reflecting the historical fact.

The S&P as a market index is about 26 percent above its own historical average. Now, when you look at a D into the weeds also provided in this chart, Is that the one sector deeply less than its own historical average is energy utilities are basically right at their own historical average. And then you look at communications, consumer staples, financials.

They're a little bit above their historical average, but not a ton, but technology is 56 percent above its own historical average. Maybe a lot of that valuation premium is warranted. Certainly, not all of it is likely to prove to be. And so you have, on one hand, A market that is overvalued where a vast amount of that overvaluation is concentrated in one sector.

Not all parts of the market are created equal right now in this valuation discussion. But then when we parse it down even further and we adjust the S&P to its own overvaluation and then look at all these sectors relative to one another, And relative to the market adjusted for its own 26 percent overvaluation relative to history, then you see the only sector above average is technology about 25 percent over and that energy utilities, communication, consumer staples, financials, materials, industrials, once adjusted relative to the S&P's current overvaluation, they're all.

Actually in line with historical average relative to one another. So both these absolute valuations and relative valuations matter. And I think if we come back to that question of whether or not current valuations are able to price in these apples of the day, these just future monumental things, We have to understand that there's three different things that one can look at.

One is that we're not necessarily talking about trying, lacking the imagination to price in Amazon in 1998 or Google in 2006 or Apple in 2013. The, some of these things just cannot pencil. Relative to valuation that the math just won't allow it that is not I've talked about this in several different cafes and I've used a Cisco 1999 analogy because I think it's one of the most powerful ones in history.

Some of these are wildly successful stories that are the input into a model. Will not allow it to rationalize the current valuation. And those are dangerous stories whereby significant value gets eroded. And one is not simply wrong on how much a company will grow, but they are wrong in what they're paying for that growth now.

And that's what the lesson of Cisco in 1999 was there's plenty of other examples that ended far more violently than Cisco. Cisco is still one of the most successful companies in the world. It's just compared to that

valuation bubble peak price it, it represented a quarter century of value erosion.

So you have to first start with wondering if the expectations that are trying to somewhat rationalize a very high valuation are even in a stratosphere of logic or common sense. And I think very often they're incoherent. Number two. There are companies that can continue compounding their growth at 30, 40, 50 percent per year, massive growth through the trees, but you cannot do that forever without eventually.

Having to develop some monopolistic tendencies that are either legal or maybe not. And that is extremely hard to do and very rare and not something often worth betting on. Most of the time, the growth rate itself has to significantly moderate because of this law of nature. And that is not usually priced in.

To the high valuation on those things. There is an assumption that a growth rate can continue that cannot without some extremely friendly relationship with government that is harder and harder to come by these days. Number three, I think this is most important. So first let's just recap.

Number one, is it that the fundamental business expectation is not really coherent to begin with? Number two, that requires a growth rate that is actually unrealistic because eventually it would have to be monopolistic to be sustained. And number three is it possible that the real advantage or the real attraction rather is not even related.

To an assumption of high growth that eventually rationalizes a high valuation. It's just hype. It's just popular. It's just a fad that it's just a momentum. It's a, this time it's different mentality. A kind of arrogance

that says you boomers don't understand that this is the new way of doing things.

To which I say, first of all, I'm not a boomer. Second of all that's. A great sign when that type of language and thinking and logic comes out to get the heck out of an investment I've seen this play out so many times. I can't count and valuation bubbles that are connected to hype when we are told to disregard the lessons of history scare me because they should scare me Now I want to make clear if someone feels comfortable on that three pronged test that there's just something that they feel Look, I know i'm paying a high valuation But I believe it checks the boxes of not being in any one of those three problems Still understand that the best case scenario is a very muted Expected rate of return because of math that when you're buying a high valuation for a high growth Investment versus a realistic or muted or moderated or sensible valuation That the best case scenario is that the expected rate of return is lower and otherwise would be, this is just math.

What I'm saying is not profound, but it should impact the risk reward calculus in that decision making. I have written time and time again, I'm going to bring this to a conclusion by pointing out that I think we live in a period of macroeconomic volatility, macroeconomic sensitivity, that the fiscal, monetary, and geopolitical conditions of our day.

Call for a bias to quality and to value and to cash flow. And that when you look at the extreme things like a Peloton in 2020, FTX in 2022, when you look at some of the silly valuation perversions of our day. Those things have to be understood as just gambling to begin with, never real investing, but those are easy parts.

Being valuation conscious and sensible because of macroeconomic conditions, that's not controversial advice. Some people may not like implementing it or know how to implement it, but it's not controversial.

Avoiding these things that drop 99 percent in your Pelotons, FTXs and all these, shiny objects, that's not controversial advice.

The hard part is when they're good companies of high valuations. And that's where I recommend starting with the three prong test, starting with the humble expectation that, okay the expected rate of return at this level of valuation is going to be less than otherwise would be. And then from there, perhaps considering if a time tested way exists to escape this madness altogether, to be focused on distributable cashflow, and that when you do focus on distributable cashflow, you are.

focusing on being removed from valuation sensitivity and into underlying business fundamentals that the investment thesis is not related to whether or not you're underpaying or overpaying at the time you buy. You are investing in a tree that continues to yield fruit, and that your valuation is measured in yield, not P.

PE, PB, PS all these different metrics that people have, if they're being honest, more often than not trying to make an intellectual case for why the fundamental metrics are justifiable, they've tried to make a funda intellectual case for why the, we shouldn't even look at the fundamentals to begin with.

That's really what most people are doing. I'm suggesting. That in dividend growth investing, you have a solution that can really deliver a very different outcome and a very different process than what so many are doing and I think will live to regret. I'm going to leave it there. Have a wonderful weekend.

We do hope you guys will be watching your television sets Friday morning, August 9th. Where you will see yours truly and my beloved partners in our investment committee Ringing the bell of the new york

stock exchange next friday august 9th the opening bell reach out with any questions at thebonsongroup.

com. Have a wonderful weekend Thank you for watching. Thank you for listening and thank you for reading the Dividend Cafe