FRIDAY, OCTOBER 18, 2024

Hello and welcome to this week's Dividend Cafe brought to you from the beautiful Newport Beach studio. My name is David Bahnsen. I'm the managing partner here at The Bahnsen Group, where every Friday we attempt to bring you some new investment wisdom, some sort of macro economic perspective, and most importantly, a practical takeaway of what it may mean to you, either as a citizen, wondering what is happening in the economic affairs of our country and our world, or more particularly as an investor who desires to see financial and mark, excuse me, financial markets attached to one's own financial goals, needs, and solutions.

The Dividend Cafe a few weeks ago was devoted to a special issue. I've done it now every four years for quite some time around the election. And what has happened out of that issue, which has been very well trafficked, both the video, the podcast listens, and particularly the written version, is a lot of questions have come in.

And I think that when you're addressing a lot of topics around the election that include the politics of it. one's expectation, certain policies that might be important to people, ramifications out of either certain policies or a broad policy portfolio in just the general direction of what it could mean, whether it's for the economy or the culture at large, the nation.

And obviously not only is there all of these different areas of interest, but in a moment of pretty heightened emotion and passions and opinions it generates a lot of differing kind of questions or whatnot. It can go in a lot of different directions and it's hard for me. to think I know exactly what people are asking about and try to address those things after the fact.

But if any of you want to send in your questions, I'm going to devote next week's Dividend Cafe. We're obviously now into crunch time here before the actual election. I'm going to devote next week's Dividend Cafe entirely to questions related to ramifications of the election, aftermath the election.

What do I think it'll mean for this or that? Perhaps it's this sector, perhaps it's something specific in international relations. I'm not going to put the ideas in your mind. Email us questions at TheBahnsenGroup. com Questions at TheBahnsenGroup. com And I will be addressing these things next Friday in The Dividend Cafe.

I think any of you watching the video or listening to the podcast probably know that this is my second or third favorite medium by which we deliver this because I am kind of a fan of the written word. And nevertheless, we know the podcast is the most popular way people take in Dividend Cafe. The video, unsurprisingly, is below that with his face made for podcast.

But the written is the origin of it. And certainly, the written word being what I enjoy doing the most. But also, where I think there's the greatest level of reader interaction, or consumer interaction in the sense that the charts and. And the the, let's put it this way, the most thought I can possibly muster going into the writing.

So, by all means, take in The Dividend Cafe however you want, just know that there's these different options. And that what I'm doing here in the podcast video is never just reciting the written. I've generally, I'm almost always, like with maybe two exceptions, I think, ever. I'm generally recording anywhere from a few minutes to a few hours after I finished writing.

But I'm not just merely reciting it, I'm redoing it from memory and trying to capture the best takeaways of The Dividend Cafe I can. But it's always centered around what the written offering is. Okay, enough context and setup let's get into it. I have been talking quite a bit, I mean, a lot of people have, but I in particular have been talking quite a bit around valuations.

Especially in this period of elevated, what's called the market multiple, which is the price to earnings ratio, a multiple being what is the number you get when you divide the earnings into the price to see what people are paying for a given level of profits. And that is historically been measured either by looking backwards, like in the past 12 months.

If a stock generated 10 of earnings per share and it's trading at 100, you say it has a trailing multiple, a P. E. ratio of 10, it can be done forward. We're expecting to make 10 and it's trading at 100, therefore it has a forward multiple. Everybody these days is going off forward multiple because the backward multiples are especially insane.

but on a forward basis, which are not unrealistic. That's one thing I want to say. Even though the forward multiples are obviously riskier than the backward multiple, why is that? Because the backward multiple has already happened, and the forward multiple we believe will happen, or hope will happen, or think will happen, but it's fallible.

But I gotta say, forward multiples have been reasonably reliant for quite some time. It's one of the true, Miracles of American public markets is the ability of companies to forecast their own profits. They can be wrong. There are disappointments, but it's so rare. And so looking ahead to some form of consensus expectation of profit and applying a multiple to that based on current price.

I've been talking all year about how we've been trading 21. 8 times. Let's call it 22 times next year's profits in the S& P 500. We've averaged something around 16, 16 and a half times. Going back 30 plus years. Now, when I say we've averaged it, I don't know that there's been a single year that it actually was at that level.

An average, by definition, is a median number, oh, excuse me, a mean number with a lot of numbers above it and below it that equal it, mathematically. The longer the period of time goes by, the difference between the mean and the median, but all we care about here is the average and that mean and that multiple has been somewhere in 16 and a half.

I've said it a lot. We've talked about what it means. The most important thing I have felt is that I do not want to be subject to some sort of major revaluation in the sense that we believe we're buying things that are appropriately priced. And as dividend growth investors, it has a bit of a more value bend, it has more balance sheet strength, which tends to put a lower multiple when you have a whole bunch of cash on the balance sheet, that's a lot of cash not going to work in productive growing things, you have less leverage, you have less debt.

All those things that can drive a higher multiple when everything's good, but of course, risk up the company and we tend to like stuff that's a bit more de risked, not entirely. There needs to be an appropriate amount of risk on a balance sheet, but we want it to be sensible in a way that it does not undermine the ability to grow distributions of cash flow to shareholders.

FRIDAY, OCTOBER 18, 2024

This is an extremely 25 years doing. Driving an investment philosophy around, written a book on, built a six plus billion dollar company around, etc. Let's hold off on that for a second because I've, I just want to explain something about the market itself. When I talk about the S& P 500, the main reason I explain this is A, the kind of historical reality of bull markets ending with multi year periods of consolidation that can have big up periods, big down periods.

but over a period of time running in place and really averaging much lower than average returns. And it's not very complicated to understand why, why would a forward period that starts at a moment of high valuation have lower expected returns? If I have to answer that rhetorical question, I probably have already done something wrong because the setup is meant to be self explanatory.

It's it's obviously math. However, the nuances around this throughout the year, I've been careful to try to give here in the Dividend Cafe. That we are really dealing with high valuations that are concentrated as the portion of the market in cap weighted, market capitalization weighted indexes, which is the gazillions of dollars in S& P 500 indexes have seen the technology and technology adjacent sectors become 40%, 41 percent of the index.

And it used to be much, much lower. It's seen a couple of companies become a massive amount of the index. Seven companies, ten companies, three companies, two companies, and even just one company become a very disproportionate factor in the index. And when you X those things out, there is a difference between a market that every single sector is pro rata overvalued and that equals an overvalued market.

There's a difference between that and what we have now where it is much more of certain sectors that are high weightings that are tremendously overvalued relative to history and then other sectors that are evenly valued. A little bit that may seem cheap or cheaper, a lot that seems. Modest, moderate fair value, whatever you want to call it, and then others that are over.

Um, we're not cap weighted investors at our company and the reason I'm writing about it this week is what, if you're not, if you are a client, ignore this for a second or understand I'm not talking to you because for people who are clients of our firm, this isn't an issue. We don't, we're not index investors.

I want to give, make something very, very clear for those who are not clients. I'm not saying you ought to go out and sell your S& P 500. It's very possible you should, but that's not what I'm saying. What I'm saying is, if you're a buy and hold strategic allocator that is just, you think you have the right blend of a portfolio, and that you accept The inevitable periods of undervaluation, overvaluation, volatility, and periods of subpar returns and over average returns, and what that will mean long term, and wish to be out of the guesswork of timing and valuation and all that, that's what you signed up for, and I'm not sure I would be doing anything different but that presupposes That somebody told you or that you know what it is you bought and why and that you know if you bought it recently what it is or if you bought it a long time ago, you know how it's changed, that you didn't used to have two companies equal 12 percent of the index or the, I don't have the exact math in front of me, but I do know The top weighted side, one company being six or seven percent, seven companies being, the mag seven being twenty percent, now higher than that.

There is a top heaviness that's different, and very possibly different than what you thought you were buying at the time. That may be fine, and it also may be that you don't even want to know what it is. You just believe in a long term buy and hold strategic allocation. I don't recommend people let their fear of valuation get in the way of what their plan was.

I just want them to know what their plan was. That's all. For my company and the way we think about equity investing, we believe the point of holding publicly traded stocks is to own a right on future cash flows and that we want those future cash flows the company generates to represent future cash flows to us.

That's what we call dividends. That's our investment philosophy. So if someone doesn't have that philosophy and accepts buying things that are higher priced and that there will be a valuation. It does not mean higher priced is that now you face an inevitable crash the next year because overpriced things get more overpriced all the time.

And sometimes they correct quickly and violently. There's a lot of that in history. Other times it's a slow burn and a muted return in an extended period of consolidation. There's any number of things that can happen out of this situation. And I don't have any forecast as to what it will be. I believe it will be a subpar result to what we're doing.

That's not anything I'd base a decision around. It's my belief that you are generating a return from something over time that is going to be more volatile, less predictable, and just different than a lot of people signed up for. So I think for a lot of folks dealing with the overvaluation of top heavy markets they're, what they ought to do is nothing.

For a lot of people, they may want to say, Oh, I did not know this is what. It was, or things have changed. I would, because the circumstances have changed, I think a change may be in order. I'd like to talk to my advisor. I'd like to sit down with my, spouse or or talk to a different advisor, whatever the case is, and map out a proper plan.

And then I think, third there is entirely the possibility of viewing it from a fully different paradigm, which is still going to be driven by investor behavior. Still going to be driven by discipline, still going to be driven by fundamentals, by not thinking one can time the market, know when overvaluation corrects, know when undervaluation rallies essentially is operating within a belief that stocks are companies.

And then I'm not trying to generate the return of an amorphous 500 stock company basket, but rather businesses that have more than one so that they're not concentrated. There's a diversification both of company and sector, both bottom up and top down diversification. But then again, it's centered around the, this cash flow generation where there's an appetite to return cash flow to me.

And that gets to the heart of dividend growth investing. I hope that makes sense. Here's what I think is going on right now. A lot of valuation thing saying, oh no, stocks are overvalued. And let's be very clear, a bunch of stocks are. That either means something to you or it doesn't in terms of actionable investment decisions based on the things I've said the last five to 10 minutes.

It is absolutely untrue that the limit to overvalued assets. is around NVIDIA. High yield bonds are trading 2. 9 percent better yield than treasuries. A bunch of S& P 500 companies, and it costs less to insure their debt than it does the United States government. Credit spreads are very tight. A lot of spread instruments, meaning debt, that trades at a spread to treasuries, is not what we call boring bonds, but it's credit sensitive.

In structured credit, in mortgages, in, in corporate debt, in bank loans, a lot of these things are very stretched in valuation too. We have to be valuation sensitive across every asset class. If people don't think real estate is over value relative to historical valuations, I got a bridge to sell you, quite literally actually.

So please call me. I'll sell you my bridge. If, I mean, this is maybe fine. Real estate does do a far better job than stocks and bonds do at allowing people to lie to themselves about the overvaluation. But no there's overvaluation in a lot of asset classes right now. The key is what to do about it.

And then the key is separating that discussion of valuation from another V word, volatility. I couldn't care less about high valuation because of volatility. It's fascinating to me. The market's doing incredibly well. It's been doing very well all of this year, with a couple tiny exceptions that were child's play.

A single digit market volatility doesn't even count. It did very well last year. Markets have been on a tear. Multiples have expanded. Earnings have grown. Volatility, though, is not really low right now if you measure it by the VIX, by fear index, by how people pay for protection. The VIX is sitting around 19.

It had been between 12, 13, 14 a lot of this year. That was very low, way too low, but regardless of what the volatility has been, It may I just don't think about these things as, Oh no, be careful of valuation because it could lead to volatility, meaning up and down movements. Volatility is a reality of liquid risk assets.

Because they're liquid, and there's a lot of people in the world that operate off emotions, they're going to be buying and selling more, and it's going to exacerbate up and down movements. And liquidity becomes a big issue sentiment becomes a big issue, you perception of macroeconomic conditions becomes an issue, and I love volatility because it enables me to make money for me and my clients off of other people's bad decision making.

But I do not fear volatility because, well, this is this really bad thing that happens. Volatility means up and down movements. I fear shiny object overvaluation because I fear not things going up and down, but things going down and staying down and staying dead forever. I fear Juniper Networks 1999. I fear Beanie Baby.

I fear Peloton. I fear pets. com. I can give you examples from the 1990s, but I give you examples from the eighties, the seventies when I was a younger lad, and I can give you examples from last month. Last year, last five years, and I promise there's more coming. And sometimes those things are to use a couple examples I gave before with Beanie Babies and Pets.

com, some of them are going to a graveyard, some are just going from a brutally high valuation to a much lower, and then staying there forever, even as a very viable company. I've talked a lot about the things bought at their peak in the late 90s, and than how they've just performed extremely well since, but their stocks are down a ton.

There's all kinds of bad things that can happen. That's my fear, not volatility. So if someone's saying, okay, wow, David's worried about valuation. He has a different investment philosophy at The Bahnsen Group and it's free from volatility. No, it's not. It, I think there's lower volatility. I just don't care.

I I care about the solvency and the extended period of muted returns that comes from buying overvalued assets, and I would like to find a system of investing that neutralizes that, and I believe we've done so. So that's the difference here in the lay of the land right now. We'll unpack this more, weeks, months, years to come.

FRIDAY, OCTOBER 18, 2024

There are a few other things here at DividendCafe. com this week about government debt. The chart of the week is very fascinating, showing scatterplot of average returns around different valuations going forward and what it could mean. Now the fund, I mentioned this before, the average return out of the S& P at 22 times going forward three years is a couple percent a year.

The average came about because of some that were higher and some were a lot lower and you can look at the chart. I hope you will. That's it for this week. Questions at thebahnsengroup. com for next week's special question election issue, as we are now less than three weeks away from that day in November, and that we're all waiting for these campaign ads to stop, for the misery to stop.

Thanks for listening, thanks for watching, and thank you for reading The Dividend Cafe.