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Well, hello and welcome to another edition of The Dividend Cafe. My name is David Bahnsen. I'm the managing partner at The Bahnsen Group. And I am excited that next week is Thanksgiving week, my very favorite holiday. Today, as I'm recording, is the coldest day of the year so far in New York, and I absolutely love it. And maybe we will get a little snow for the Thanksgiving Day Parade. Next week with Dividend Cafe, because of Thanksgiving, and the fact that everyone will be with families and dealing with turkey hangovers on Friday, it's We'll do what we've done for many years now, which is skip the Friday Dividend Cafe and instead, on Wednesday, put out a kind of Thanksgiving edition of Dividend Cafe. This coming Monday, we'll have the normal Monday Around the Horn version and then we'll get back on track the week after.

Today, I am not avoiding politics in the election, but we're also not devoting our entire time. To that subject, which is what we've done for several div cafes in a row, you know, you basically last week had a very comprehensive summary of some of the policy aspects that we're expecting coming into the new administration in the aftermath of President Trump's reelection. The week before was the week of the election. And so we tried taking a stab at it then. And then of course, you know, had much

more limited information in the first few days than we've gotten since today, I want to talk about some things non election related, but there are a few other pieces we'll get to as well, and I'll save that for the end.

Just dealing with the personnel and the administrations plans for staffing and so forth. So we'll get there at the end. Let me start with what will probably be our biggest topic today, which is index investing and its impact on non index investors. And what I mean by that is, you know, for those of you who are listening who are clients of The Bahnsen Group, you know, that we're active investors. We have a philosophy in our U S equity exposure that centers around dividend growth stocks, and we tend to not take an approach that is indexable or passive or let alone owning, you know, let's say, 500 companies. And I talk a lot about the kind of mathematical reality of index investing. The great thing about it, of course, is you get exposure to the U S stock market and you do so at a very low cost of ownership.

And one of the kind of changing dynamics that I've spent most of my time commenting on that people are welcome to take as a sort of neutral statement because it doesn't necessarily imply something positive or negative. It just is math. Okay. Which is the concentration reality that, you know, right now there are seven companies that are 33 percent of the index. And that means there are 493 companies. that are 67 percent of the index. And those seven companies that are 33 percent now were about 10 percent less than 10 years ago. So, you know, the, that's a substantive change that I've always just said, I

want people to be aware of and understand, but I don't think it matters to me.

It doesn't matter to the Bahnsen Group or our clients. And so I share it in terms of its overall efficacy and understanding markets. But I would argue that while the concentration dynamic of index investing is not directly relevant to people who don't themselves have exposure to it, that there are other components of the massive growth of passive ETF or index investing that is relevant to even people who don't own such.

And that it's relevant in the form of what it does to exacerbate volatility and what it may do to alter liquidity. And then in both cases, I think it's rather clear that these things exist and affect all investors. And I don't care at all. First of all, as it pertains to the general how liquidity factor, let's just start there, but understand that the elasticity of investing and the way in which investors go buy a mispriced securities is changed on the margin when there's less investors looking to buy mispriced securities and more investors, That are simply buying all securities, mispriced, overpriced, underpriced, regardless.

Just that passive, by definition, passive approach. Now, this takes away an opportunity set for active managers in the sense that we start with the basic mathematical premise. It's not a premise. It's a tautology. It's intrinsically true that excess returns are zero sum. You know, there are plenty of investors that get excess returns, but they are getting them at the cost of others,

and that isn't for any good or bad reason, it's a mathematical reason, right?

If everybody's returns were excess, they wouldn't be excess, and so, the sum of parts. is market returns. And then it is total investor returns. And then excess above and below that are a result of decisions and trades and approach and, you know, the results that individuals generate.

And so when there's less, I mean, an awful lot of the opportunity set for active managers has always come from a certain percentage of investors out there that are what we would call noise investors. They're generating a lot of noise. They're not necessarily super good at it and they, therefore, in their buying and selling, create opportunities that can lead to bad investment decisions for one, but good investment decisions for the other.

This is a kind of a classic Warren Buffett situation where he generated a lot of excess returns over the years. By buying from people who are generating a lot of negative excess, excess returns. And so this dynamic, when you have more and more people passive investing is mitigated, right?

And so that's a good thing in aggregate, right? For society. Okay. However, then there is less liquidity or providers of liquidity for mispriced securities. So a mispriced security may end up staying mispriced longer and whether we're talking about seconds or years it's probably neither, but the point being on the margin, there is some enhancement of illiquidity when

there are less people that are providers of liquidity when, in occasions of mispriced securities.

And all of this is begging the question about what's mispriced and not, but it's irrelevant to the mathematical point I'm making. Now the exacerbation of volatility should be a very non-controversial statement in the sense that momentum is a self reinforcing mechanism, and there's a lot of momentum for large cap growth stocks.

that then now have big force to buyers when there are hundreds of billions of dollars of people buying big cap ETFs. But that is not necessarily a byproduct of only brand new money. If it is coming from small cap, mid cap, value, other components, then what you have is greater demand for a single concentration sector, element, you know, factor, and then decreased demand in others.

And that can lead to mispriced securities. Now, some would say, oh, this is a negative because there's less and less people now buying small cap. But again, for a value investor, this is the greatest thing you could ever want to hear. I'm making up a small cap as an example, which by the way has had a huge run in recent months as we've talked about.

My point is that these things generally momentum in one place could mean a value opportunity in another. And I see that as a very good thing. I don't care. Now, the volatility element is important because it exacerbates the possibility of people that

are not necessarily the best behavioral investors of when things stop going in their direction with momentum.

Being far more inclined to, to panic or sell on the other side. So all of this stuff look, pa I think 10 years ago, passive investing in terms of all the ETFs and funds out there were 25% of the market and now it's over 50%. So it's doubled in a little over 10 years. That has facilitated a lot of the momentum in that space.

And then of course. You know, things like these mega mag seven mega cap names becoming, you know, such a disproportionate amount of the index is a result. And I don't, I've said what I believe, how concentration volatility. Momentum and liquidity impacts us, either not at all, or I think opportunistically.

And for investors who are in that, I've written before in dividendcafe.com, it was about four or five weeks ago before this big election season, that dedicated DivCafe to what I think it means for them. Because it's entirely possible that for them, they should just ignore it and let it play out and be that buy and hold index investor.

who gets a market return and if market returns end up being below average for a few years and they know that's a possibility and they have 20, 30 years and whatnot, I don't have anything to say about that. I just don't think that there's a lot of people out there who understand that, who understand the level of PE ratio that they're buying right now who understand averages, who understand how hard it is to time any of this and

who understand the math of, 493 companies of their S&P 500 being much less than they used to be.

So the behavioral expectation of what someone ought to do about that is different because I can't comment, nor would I comment on what non clients of ours ought to do behaviorally. But what we do behaviorally is construct a plan we believe in and then work day and night to stick to that plan to the extent that we recognize the tendency of human nature to get in the way of good plans.

And our plan is centered around dividend growth and value and cash flow and fundamentals that we think drive returns over time. It's not driven by momentum, but momentum can generate wonderful returns for a period of time. And momentum can take away a lot of returns in a period of time, because that's what the definition of momentum is.

All right, we'll move on from that spreads. A spread is, you know, I'm always trying to make sure I speak in a way that human beings can understand. And so I go out of my way sometimes to say things like high yield bonds are trading at 2. 67 percent over treasuries. And that is true. But in my world, we just say high yields 267 wide or spreads are 260, 267 basis points.

And, you know, you don't save a ton of time, but when you're using these things in sentences repeatedly and in contrast to other data points, and it can all add up, you don't have time to

spell it all out. But that's all we're talking about. A spread is how much yield an instrument is paying over what the comparable treasury would be a safe rate to evaluate its safety and its attractiveness in the market.

And when high yield bonds. are right now at 267 over treasury. That's close to the tightest they've ever been. Meaning that a high yield is very rich investment grade bonds that are much higher quality than the low quality of high yield are only 80 basis points over treasuries. So the corporate debt side is very rich.

And we know this as to why. For boring bond investors, treasuries have a very good weighting because you're not getting paid a ton of extra yield for that additional risk and what not. Now, with co commercial mortgage backed securities, CMBS. This is one area of the market of all these different spread instruments, of all these different fixed income and asset classes that trade at some spread over treasury.

CNBS is one that unlike high yield, unlike corporate bonds is quite rich and excuse me is quite wide and it's not as like after the great financial crisis that was absurd. And then during COVID things blew out as people worried about where retail and office and things, and then narrowed a lot and it got to only be 250 wide during 2021 and then the Fed began tightening. There were some high profile defaults in the office space. And then people started throwing the baby out in the bathwater and a lot of like triple B, CMBS went very wide. Today, it's well off of the lows and well off the highs, but still sitting, you know, where

an investor in triple B commercial mortgage backed securities might be getting six to six and a half percent over treasury.

And that reflects a lot of the perceived risk and the inefficiencies. It's a lot more illiquid of a market, but it is not a monolithic market. I mean, high yield bonds have a very high correlation to one another. Credit tends to be very pro cyclical. Commercial mortgage backs right now, there's very big differences between single asset multi family.

You know, I've talked a lot about the difference between offices in high class A offices in New York City versus class B offices in San Francisco. There's just no comparison, right? So, for better or for worse, CNBS is a space that's worth looking at. Indicating with 800 billion of debt in this commercial real estate world, that there's something to be concerned about or a great opportunity for investment or what we believe.

Both. There is risk and reward and it's a very bespoke asset class that requires very idiosyncratic management and understanding. Axios reached out this morning to me and I haven't seen if they run a story yet and quoted me in it or not. For my comment on a survey they ran, Where they asked a bunch of people from each different age group, what they thought the income was one needed to be financially strong, financially secure and Gen Z, which is let's call it, you know, 18 to age 28 or so had a 600, 000 plus number as to what they thought it meant to be financially secure. And Axios question for me is, do I think that reflects anything in particular? Why their

number, where the average across all surveys was like 270, 000 is when you're really financially set in income. And why did Gen Z have such a higher number?

And then did I think that was related to more young people moving to the right in the most recent election? And what I said to them was. I think it's almost entirely about housing. That I understand groceries are higher and student debt is out there and whatnot. But if you have a good job, you're making good money and you need a roommate to pay your rent, you don't feel like you're doing well.

And if you're doing well and you have a good job and yet, you can't afford a down payment on a home because it's so expensive to get there. The income level required net of tax to kind of feel in that position. Gen Z feels it differently. And so I, and that pressure, that age, that to be have arrived and then signify it with, you know, living in a good place, having some independence and maybe even buying a home or just affording expensive rent, you know, I think that's really driving that answer.

And then, do I think that the election was capturing some of the sentiment of young people? A lot of it is just that the Democrats were president the last four years and in charge in the Senate, and for two of the last four in the House, and, so they're, my theme last week about anti incumbency being a global political dynamic right now, I have a feeling more of that is just anti incumbency than anything in particular.

But I do think that the exit results show from the polls a strong sense that a lot of the younger people, even if they ideologically have some sympathy with some of the DEI, Diversity, Equity, Inclusion movement and ESG movement, don't feel that they're getting ahead in their own careers meritocratically the way they feel they deserve to.

And I think that's an interesting dynamic that's worth watching on the margins for that sentiment, how it plays in to professional decisions, the economic impact, and then of course, you know, I was asked about it from an electoral impact standpoint. But that housing factor is so big and no more so for folks that are at the older side of Gen Z and even the younger side of Gen Y.

So I said I'd mention quickly some of the economic stuff about the administration. I really stalled recording and submitting my writing as long as I could, just in case President Trump announced any economic cabinet picks this morning, but as I'm sitting here recording, he had not we know that Howard Lutnick was moved to the Commerce Department, Linda McMahon was moved to the Education, she had been slated for Commerce Lutnick had wanted Treasury, but got Commerce, and so that leaves the Secretary of Treasury.

The Director of National Economic Council and the Chairman of the Council of Economic Advisors and the U. S. Trade Representative. Basically, you could argue four of the five largest the two largest economic announcements and four of

the five largest are still unannounced. The candidates out there are being discussed heavily in the news.

I do believe that there's a chance that grows by the day. The President Trump is gonna ask his people to start over entirely. The fact that he's done the interviews hasn't made an announcement. Maybe they're still doing some more background checks. I don't know. I'm trying my very best to get more information, but I think everybody I'm talking to is a little confounded too.

I will say I like the main candidates I'm hearing presented. I like Senator Hagerty in Tennessee. I like Scott Besant as I've talked about and then Kevin Marsh for I like a great deal. So there's some good options out there, but nothing is set yet. So it's very difficult to comment on it. Now I've talked to a couple of weeks in a row and done media hits and so forth on this doge, this department of government efficiency.

And what I see are both possibilities and opportunities from it, but also just some headwinds or skepticism I would have. With two big private sector success stories like Elon coming in and trying to clean up gov government. And the only thing I would say is, I really liked one thing that they did this week.

It was announcing that there will be a mandate to return federal government employees back to the to work five days a week. With COVID being Done like four years ago. I think a lot of people are kind of surprised They haven't gone back to work.

Most of the private sector has made comparable announcements But if the goal is to drive more productivity Then you're gonna get more productivity and people go to work and if the goal is to cut cost You're gonna get cost cut what a lot of people quit because they were mad that they had to go back to work So I don't know if there's teeth in this or not But I just think this is indicative of maybe a step in the right direction Those who know me and know how I feel about remote work are aware that I most certainly would apply it.

To government employees. So this is interesting. Okay. We'll keep our eyes on that. The chart of the week at dividingcafe. com. Not concerning yet, but just something to watch around revenues. If you need profit growth to get expected returns in stocks next year, profits need sales growth. And if sales growth is going to underwhelm in the S&P 500 and even in small business, there's a little bit of question as to whether or not the NFIB Small business optimism is struggling around expectation for top line sales growth.

That's something we're watching. So great chart there to pour more into that. I'll see you back on Monday. In the meantime, have a wonderful weekend and go Trojans, beat the Bruins. Take care. Thanks for watching. Thanks for listening. Thank you for reading The Dividend Cafe.