The Conservative Strategist

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Only three drivers of stock prices

In these days when stocks are pushed and pulled by the next Trump tweet about China, or the next move by Iran or Saudi Arabia, it's a good idea to remind ourselves that there are only three long-term contributors to stock returns: dividends, earnings, and valuation.

Dividend Yield: Skimpy

Today's dividend yield on the S&P 500 (1.89%) is near the lowest of all-time except for the years 1998 to 2001 (which was not a great time to buy). It's lower than the level before both the 1929 and 1987 crashes, and before the long bear market of 1966 to 1982. Some argue that dividend yield is deceptive because today, corporations opt to buy back their own stock as a way of returning value to shareholders, rather than through dividends. The notion of *shareholder yield* (dividends *plus* buybacks) has gained some credence. According to analyst Ed Yardeni, total shareholder yield on the S&P 500 is slightly over 5% currently. However, this ignores the facts that many if not most companies have tended to issue buybacks when their stock was overvalued, actually damaging shareholder wealth.

Earnings: Vulnerable

No question, stock prices have tracked the growth of corporate earnings over the long run. And over the same long run, earnings have risen many-fold. Last quarter's $2 trillion in annualized total profits was twice that of a decade ago. But there are long periods of time when earnings go nowhere.

Headwinds vs. Tailwinds

Research Affiliates' estimate, September, 2019: Large-cap US stocks *vs.* emerging markets stocks and 10-year expected real return and components

FACTOR	US LARGE COMPANY STOCKS	EMERGING MARKETS STOCKS
Annual real return	**0.7%**	**7.7%**
Dividend yield	2.0%	3.3%
Earnings	1.2%	2.8%
Valuation	-2.5%	1.6%

RA projects less than a 1% annual return above inflation for the S&P 500 over the next ten years, with all three components either meager or negative. Its emerging markets estimate shows more robust contributions from all three factors, resulting in a real return estimate seven points higher.

And of course, there are periods when earnings plummet — recessions. In the financial crisis, they were even thrown into reverse, with thousands of companies reporting steep losses.

Earnings do especially poorly after profit margins hit peaks as they appear to have done recently. And today, trade wars, rising wages, and increased competition among the big tech firms are all pressuring corporate earnings.

Valuation: Near all-time highs

Valuation depends largely on investor perception and emotion, and so can move stock prices faster than the other two factors.

When valuations are low, expected forward returns tend to be robust. When valuations are high, forward returns can be low or even negative. A reliable indicator of valuations? The 10-year cyclically-adjusted price-earnings (CAPE) ratio (also known as Shiller PE, after Yale professor Robert Shiller). It's a no-nonsense measure of stock prices compared to corporate earnings, smoothed over ten years to eliminate volatility. Its *very* long-run

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The Markets September 30, 2019	Price/Yield	Gain, Qtr	Gain, YTD
US Stocks (S&P 500/Vanguard Index)	2976.74	1.67%	20.44%
International Stocks (Vanguard Index)	16.57	-1.58%	11.42%
Emerging Markets Stocks (Vanguard Index)	25.60	-3.65%	7.97%
Real Estate Stocks (Vanguard REIT Index)	30.99	7.39%	28.03%
Bonds (30 year US Treasury/Vanguard Index)	2.12%	7.80%	19.20%
Dollar (US Dollar Index)	99.38	3.38%	3.34%
Gold (London Afternoon Fix)	$1489.90	5.74%	16.49%
Money Market Funds (Vanguard Prime – SEC yield)	2.02%	-0.36%	-0.40%

*change in yield

Portfolio Planning

A bad idea rich people love (and alternatives)

With interest rates near the vanishing point and risk assets in the stratosphere, projected returns are meager, even negative, for most asset classes. Some wealthy investors are stretching for yield, others for growth. Some in the latter group are hearing the siren song of an alluring but dangerous form of investment: Private Equity. As we'll see, the small investor can find a simpler and superior alternative on the New York Stock Exchange.

Private Equity: Five ways worse than stocks

Private Equity (PE) partnerships buy private companies with leverage, often to restructure them and sell at a quick profit (or buy public companies and take them private). Largely on the back of spectacular results from a few funds, PE has become the rich investor's playground, with $582 billion in buyout deals done in 2018, according to PE firm Bain & Company. Pension funds, endowments, and even insurance companies have also become heavy investors, with 89% of corporate pension plans owning some form of private equity in 2018.

But recent studies have challenged the wisdom of such investment. Some show that after their staggering fees, PE funds actually perform no better than the S&P 500. And adjusted for their much higher risk, they substantially underperform. PE is not as good as it looks, for at least five reasons: ***Leverage, illiquidity, fees, selection risk,*** and a ***socially dubious process.***

Leverage works both ways

PE is the kinder, gentler term for what used to be called *leveraged buyout* funds. Leverage is integral, and sometimes amounts to several times the value of the company acquired by the PE fund. It's like buying a house with 5% down. It can work out great. But sometimes debt can break a weak company. And sometimes the economy turns lower, and there goes your sliver of equity. Compound that with the fact that most PE funds just invest in a few deals (would you buy a mutual fund that owns just four or five stocks?), and you have a prescription for very high risk.

Eeeny-meeny-miney-uh-oh

Selection risk is huge for PE investors, because the dispersion of returns among PE funds is exceptionally wide. In many years, the average top quartile and bottom quartile funds are separated by 15 percentage points of return. And good luck using track record as a guide: Studies show that as the industry has matured, persistence of returns has diminished to the point that it's nearly a crapshoot to pick one of the minority of winners.

To reduce selection risk, you'd have to diversify among a number of PE funds. Given investment minimums, that would take millions of dollars. And since PE should only occupy 5% to 10% of your portfolio allocation, it means that you'd need a net worth of $100 million or more for adequate diversification.

Fees can be astronomical

Once PE funds lever up, they charge fees based on the nominal amount of the investment, not the actual amount invested. And fees can include both annual charges and performance

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Hail Yale? Not so fast.

Return and risk of a passive small-cap-value-stock portfolio compared to the buyout portion of Yale's endowment, 1987-2014, annual returns

	UNLEVERED SMALL-CAP VALUE PORTFOLIO	YALE ENDOWMENT BUYOUT PORTFOLIO
Average annual return	19.27%	18.47%
Standard deviation	17.40	19.01
Sharpe ratio	0.90	0.78
Worst calendar year	-21.28%	-25.90%

Yale University's endowment portfolio has been hailed as legendary by the investing community, and one of its seeming secret sauces is its stake in private equity (PE) funds that specialize in buyouts. Since PE funds select stocks that fit the small-cap value category, a more-than-fair basis of comparison is the return of a passive index of small-cap value stocks (PE is levered and thus intrinsically higher risk). Over the 27-year period, Yale's buyout sleeve failed to beat the passive index, and assumed slightly higher risk. And this is before considering the liquidity advantage of owning stocks versus private equity funds. *Source: Erik Stafford, "Replicating Private Equity with Value Investing, Homemade Leverage, and Hold-to-Maturity Accounting", Harvard Business School, Spring 2015*

Stock price drivers

(Continued from page 1)

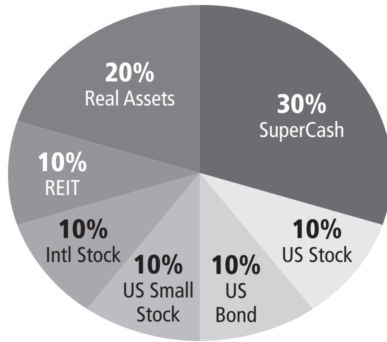
average is 16.65. In late September, it stood at 29.81. That's higher than the 1929 peak, higher than before the 1966-1982 bear market, and considerably higher than before the 1987 crash. It's been exceeded only for about 40 months at the height of the dot-com craze.

So turn off all the short-term noise. Over the long-run, stocks move from these three drivers. And today, they are not supportive. Dividend yield is a thin reed, and buybacks are a two-edged sword. Corporate profit margins may have peaked, and earnings are under pressure from several factors, with a recession looming. Valuations are sky-high. Investors face some mighty headwinds. ■

SuperDiversified Portfolios (SDPs)

Trade vacillation damages investor confidence

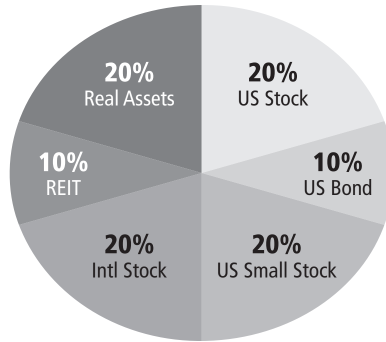
SDP1 *Conservative*



3rd Quarter **1.09%** *Year-to-Date* **11.87%**

While risk assets made little progress on-balance in Q3, day-to-day volatility has been increasing, with a 5% swoon in late July/early August followed by sharp weekly back-and forth movement into late August, and then a full recovery into mid-September.

SDP2 *Moderate*



3rd Quarter **0.61%** *Year-to-Date* **15.58%**

With respect to the trade tensions with China, the volatility is mirroring the nearly daily on-again/off-again rule-by-Tweet approach of President Trump. This vacillation should heighten business uncertainty and impairs planning. But so far, markets remain resilient.

The above model portfolios are not intended to indicate the performance of any real account, but reflect the composite performance, before fees, of the percentage allocations in the asset classes and funds listed in the table below. Seasonal Strategy's actual allocations vary from these models, and among portfolios.

How the Sectors Performed

SuperCash looks better in low-return quarters

Asset Class	Mutual Fund	Performance 3rd Quarter '19	Performance Year-to-Date	
SuperCash	PIMCO Instl Low Duration	0.78%	3.91%	Best
	Merger	1.72%	4.20%	Worst
	Calamos Market Neutral	0.97%	5.25%	
US Stock	Vanguard Index Trust 500	1.67%	20.44%	
US Bond	Vanguard Long-Treasury	7.80%	19.20%	
US Small Stock	Vanguard Small-Cap Index	-1.49%	17.68%	
Intl Stock	Vanguard Intl Index	-1.58%	11.42%	
REIT	Vanguard REIT Index	7.39%	28.03%	
Real Assets	PIMCO Commodity Real Return	-3.16%	5.18%	

In quarters like this one, when risk assets are mixed, the slow and steady returns on our SuperCash funds look fine by comparison, especially when measured on a risk-adjusted basis.

This quarter, the slightly more than 1% average return of our SuperCash funds works out to 4%+ annually, roughly two-and-a-half points above the current inflation rate. The return is not spectacular, but the risk level is fairly impressive — roughly one-sixth that of the S&P.

WeWork

"The biggest casualty of the postponed initial public offering for We Co., parent of the office-sharing business WeWork, isn't the company or its bankers. It's the myth that private markets are superior to public markets.

Investors have long been told that the stars of the financial universe are hedge fund, venture capital and private equity managers. These supposedly visionary geniuses are said to be immune to the short-term thinking that poisons the public markets. Investment horizons should be longer, risks lower, returns higher.

Since 2008, pension funds, university endowments and other giant investors have poured roughly $2 trillion into private vehicles on that promise. Individual investors have seldom been allowed past the velvet rope — but, as the We debacle shows, that isn't always a bad thing.

Not long ago, We's venture-capital backers valued it at $47 billion. The proposed IPO faltered when public investors signaled they wouldn't value the company much above $15 billion — implying the supposedly sophisticated private market had been pricing We at roughly three times what it is worth."

— **Jason Zweig**
"How We Should Bust an Investing Myth"
Wall Street Journal, September 20, 2019

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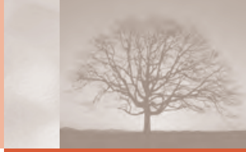

A bad idea rich people love (and alternatives) *(Continued from page 2)*

incentives, often comparable to the 2&20 of hedge funds: 2% per year and 20% of profits. This can total 3% to 5% per year or more overall. Over the five-year life of a typical fund, assuming a modest growth rate, this can amount to a third or more of your original investment. It's a fool's errand to assume that one can overcome the drag of fees of this magnitude.

Want your money out? Good luck.

Stocks are liquid. PE is not. Most partnerships last three to seven years. A portion of the original investment may be returned to investors along the way, as deals conclude. But limited partners have no control over that schedule. Even the general partner has limited control over sales. If the economy turns lower, all bets are off. Investors deserve a return premium for the illiquidity of PE, but don't receive that premium, according to a number of studies.

Social (ir)responsibility

Finally, PE can be a feel-bad investment. Too many times, PE firms load acquired companies with debt, and restructure by firing hundreds, even thousands. To maximize short-term profits, longer-term values are sacrificed. Investors may be enriched, but often cultures and communities are torn apart and we all end up a little poorer for it.

Bottom line

There's nothing magic about private equity. After fees, it has performed no better than public markets, but with greater risks, less liquidity, and higher costs — both financial and social. Most or all of the excess returns of private equity go to the general partners (organizers), not the limited partners (investors). ■

Three alternatives to private equity

The motivation to own private companies is sensible. They offer diversification to most investment portfolios (though they aren't well-diversified themselves). And today, when most public securities are overvalued, it's reasonable to search for value among non-listed businesses. But there are three ways of investing publicly in private equity that may sidestep some of the caveats noted above.

1 THE MAJOR PUBLICLY-TRADED PRIVATE EQUITY FIRMS

The stocks of at least seven giant private equity firms trade on the New York Stock Exchange. As a shareholder, you share in their revenue and earnings.

ADVANTAGES: Much better liquidity than owning a PE partnership; more diversification, since you benefit from all of the firm's operations, which may include private equity, venture capital, and even hedge funds; and perhaps most importantly, the firm's high fees work in your favor — as they grow, so do earnings.

DRAWBACKS: The track record of these stocks are mixed. Their accounting, as Buffett notes, is opaque. And like their partnerships, they are more volatile than the S&P. In a deep market selloff, they may tank.

2 BUSINESS DEVELOPMENT COMPANIES (BDCS)

BDCs are publicly-traded investment companies that invest in small-to-medium sized companies, usually lending money, sometimes taking an equity stake, and adding value through their advice. Like REITs, they are pass-through structures, and so distribute the lion's share of their income through a dividend. They are organized like closed-end funds, and so their stocks can trade at a discount (or premium) to their Net Asset Value (NAV).

ADVANTAGES: Liquidity; high yield; moderate leverage (BDCs by law are capped at 2:1 leverage); diversification among the BDC's investments, often in the dozens or even hundreds; and for the patient investor, healthy discounts to NAV that can raise effective yield and improve appreciation potential.

DRAWBACKS: BDCs have exhibited unimpressive total return records, by and large. The competition for middle-market lending is fierce. Some BDCs charge high fees.

3 BERKSHIRE HATHAWAY

Today, Warren Buffett's company is a $500 billion behemoth, but only $200 billion is invested in public stocks. In recent years, he has raised his stake in private companies faster than in stocks, and now owns at least 63 firms outright. Unlike private equity firms, Buffett buys great managements and then lets them do what they do best with a minimum of interference.

ADVANTAGES: Selection and monitoring from the greatest capital allocator of our time; unparalleled track record: 1.8 million percent increase in the stock price since 1965; permanent source of investment capital, owing to the float from Berkshire's insurance operations; effective expense ratio of a few basis points per year; huge cash reserves for acquiring bargains in a bear market; and a disciplined buyback program from Buffett that puts a hard floor on Berkshire's valuation.

DRAWBACKS: The public stock portfolio is not nimble. Positions are gigantic, with huge embedded capital gains. Buffett is 89 and won't live forever, though he has done a fine job of hiring top-notch managers who will carry on his legacy.