MARKET UPDATE

Fiduciary Financial Group

Calendar Year 2024 Snapshot

Asset Class Snapshot	12/31/24
Asset Class	**YTD Return**
U.S. Stock	23.81%
Global Stock Ex U.S.	5.53%
U.S. Real Estate	4.86%
U.S. Bond	1.25%
Global Bond	-1.69%

Region Snapshot	12/31/24
Region	**YTD Return**
U.S. Stock	23.81%
Asia Pacific Stock	9.56%
Emerging Markets	7.50%
Global Stock Ex U.S.	5.53%
Europe Stock	1.79%
Latin America Stock	-26.38%

Equity Style Snapshot			12/31/24
YTD	Value	Blend	Growth
Large	16.00%	25.15%	32.73%
Mid	14.04%	15.25%	16.48%
Small	12.42%	14.21%	16.48%

Asset Class Summary							12/31/2024
Asset Class	**1 Week**	**1 Month**	**3 Month**	**YTD**	**1 Year**	**3 Year**	**5 Year**
U.S. Stock	-1.45%	-3.06%	2.63%	23.81%	23.81%	8.01%	13.86%
Global Stock Ex U.S.	0.15%	-1.94%	-7.60%	5.53%	5.53%	0.82%	4.10%
U.S. Bond	0.19%	-1.64%	-3.06%	1.25%	1.25%	-2.41%	-0.33%
Global Bond	0.00%	-2.15%	-5.10%	-1.69%	-1.69%	-4.52%	-1.96%
U.S. Real Estate	0.32%	-8.20%	-7.78%	4.86%	4.86%	-4.14%	3.00%

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January 2025

In April 2008, Barron's published its semiannual poll of professional money managers, revealing widespread optimism about the market. Floyd Norris of *The New York Times* highlighted some of the poll's most striking findings:

- Over 55% of participants believed the market was <u>under</u>valued.
- Only 10% felt it was <u>over</u>valued.
- A staggering 87% expected to be <u>net buyers of stocks</u> in the coming months.[i]

Fast forward ~11 months: the S&P 500 had declined by nearly 50%. Meanwhile, the "boring" Barclays US Aggregate Bond Index delivered positive returns.

For those who just want the broad strokes

Looking back, it's clear how market narratives and short-term optimism can mislead investors into decisions that deviate from long-term success. The insights shared here reaffirm our belief in enduring principles: diversification, valuation awareness, and forward-looking strategies. We view these as the foundation for navigating market cycles and achieving financial goals.

While U.S. equities have led recent returns, current valuations and structural imbalances suggest a need for caution. Despite their drag on recent performance, we remain steadfast in our recommendation to incorporate meaningful exposure to international equities, fixed income, real estate, and alternatives, all of which offer compelling opportunities when approached with discipline and a long-term perspective. International markets present attractive valuation gaps and the potential for mean reversion. Fixed income provides not just stability but competitive yields relative to expected equity returns and current levels of inflation, while real estate continues to play a critical role in diversification and capital appreciation, particularly through private and diversified approaches.

Alternatives, often underappreciated in traditional portfolios, also deserve attention. Hedge funds, private debt, and commodities may not deliver stock-like returns but have proven their value in reducing risk during "tail events" and enhancing portfolio resilience. These instruments, used prudently, complement traditional assets by addressing risks that stocks and bonds alone cannot.

At FFG, we remain focused on helping clients avoid the pitfalls of chasing recent performance (recency bias) or reacting emotionally to market volatility. Instead, we prioritize building portfolios designed to endure market challenges, balancing risk and return to align with financial objectives.

As always, we welcome the opportunity to discuss how these insights apply to your unique financial situation. Together, we can navigate these dynamic markets with confidence, discipline, and a clear focus on the future.

Referencing back to the Barron's publication, we see with the benefit of hindsight just how challenging, and, some might say, ill-advised, it is to predict short-term market movements. At FFG, we recognize that no one can know for certain which way the market will turn. Instead, we rely on time-tested principles that have demonstrated their value over the long run. We consciously avoid the temptation of short-term forecasts, the lure of fleeting trends, the "this time is different" mindset, and any departure from these core principles that support lasting success. In addition, our portfolios are structured to help investors meet their goals without taking on excessive risk.

So, what are our core principles?

1. **A client's financial plan drives investment decisions**
   - When conducting financial projections for our clients, we first identify the target amount to be reserved in assets that are reliable in delivering (a) capital preservation, (b) sufficient liquidity, and/or (c) reliable cash flow to endure prolonged market downturns. For the portion of the allocation to be invested in "risk-on" assets that typically provide long-run returns in excess of inflation, we initially evaluate the portfolio growth rates required to achieve a client's goals. We then consider the trade-off between prioritizing "maximizing total return" and "maximizing the predictability of returns at levels sufficient to meet those goals." Our default approach prioritizes the latter, leading to the construction of portfolios designed to significantly reduce the magnitude and likelihood of extreme outcomes - both substantial losses and outsized gains - often associated with volatile market conditions.

2. **Prioritize meaningful portfolio diversification to achieve target return**
   - The focus here is on constructing a **diversified** portfolio to both control overall risk and achieve the targeted absolute return. By its nature, the truly diversified portfolio will not generate returns as high as the best-performing asset class but will outperform the worst-performing asset class. The goal being to avoid or greatly mitigate the years of significant losses. The most commonly cited "diversified" investment is the S&P 500, but as we'll see below and cover in depth in the accompanying slide deck, is not providing the diversification some people me think.

     - 2000-2002: S&P down ~50% | Nasdaq down ~78%
     - 2007-2009: S&P down ~57% | Nasdaq down ~53%
     - 2020: S&P down ~34% | Nasdaq down ~29%
     - 2022: S&P down ~25% | Nasdaq down ~34%

3. **Valuations matter**
   - Although metrics like the Shiller P/E may not predict short-term market movements, they play a significant role in forecasting long-term returns (of 10 years or more). Context is crucial; valuations should be assessed relative to historical norms and alternative investment opportunities. The greater the number of valuation metrics indicating an extreme environment, the more prudent it is to focus on risk mitigation and proceed with caution.

4. **Look to the future, not the past**
   - Recent strong performance is not an indicator of future success. Markets are inherently forward-looking, and prices often reflect expectations of future growth, profitability, and economic conditions rather than recent returns. Historical examples like the late-1990s tech bubble or the mid-2000s housing boom illustrate that assets enjoying rapid gains can suffer just as dramatic downturns from these elevated positions when expectations change.

Where the Market Sits

The US Stock Market

Depending on the metric, there are only two other instances in history where the S&P 500 index appeared so overvalued relative to its own history and relative to other major global stock markets. One of those times was in 1999, with the following 10-year period showing negative returns for the index, later termed The Lost Decade. The other instance was in Dec'2021 after which we saw a ~25% price decline from the peak in just nine months. **So, what evidence do we have to support our stance that (a) this index is overvalued, and (b) superior options exist in other stock, bond, and real estate markets? We will review our logic briefly in the bullet points below, and in more detail in a chart deck coming soon.**

- **Record-setting index concentration:** The aggregate value of the largest 10 companies in the S&P 500 is now equal to the value of ALL publicly listed companies in the UK, France, Germany, and Japan, combined (no, you didn't read that wrong).[ii] Prior periods of extreme concentration (1932, 1964, 1973, 2000) were all associated with well-below-average (and in some cases negative) forward 10 year returns.[iii]

- **Extreme CAPE ratios:** A recent article in "The Economist" from December 2024 noted that the current CAPE ratio, popularized by Nobel Laureate economist, Robert Shiller, is at a staggering level of 38. From starting points where the ratio was at this level or higher (only observed in the tech bubble), the index has never produced a positive return over the following decade.[iv]

- **Negative equity risk premiums make the additional risk in US growth stocks (the largest representation in the S&P 500) harder to justify.** Historically, investors command a higher yield from earnings on stocks, vs. coupons on treasuries, as the risk associated with stocks is so much higher. Right now, the relationship is negative with the S&P 500 earnings yield at 3.59% and the two-year treasury yield at 4.24%. The last time we had an extended period of a negative spread? You guessed it… The late 1990s leading up to the tech bubble collapse.

- **Major money management institutions appear fairly united in their expectations of sub-avg S&P 500 performance for the next decade.**
    - Vanguard – click here
    - BlackRock – click here
    - Fidelity – click here
    - Schwab – click here
    - Goldman Sachs – click here

Note: *It's important to highlight here that sweeping changes across the board (from US to INTL equities) in client portfolios is ill-advised and such shifts need to be made on a case-by-case basis. While major rebalancing trades are easy to make with retirement accounts (due to lack of tax impact), many of our clients' overweight allocations to US equities are difficult to unwind in taxable accounts, particularly with large US stock positions that have been held for several years. While we are NOT against such shifts, and often have to remind our investors that paying taxes on portfolio gains is the only way to make such returns "real", we prefer to make these decisions hand-in-hand with our clients given the tax bill that often ensues.*

While concerns persist regarding the overvaluation of the large-cap, growth-heavy S&P 500, value-oriented U.S. stock segments, particularly small-cap and mid-cap stocks, are trading at more historically reasonable valuations. Notably, small- and mid-cap value stocks have delivered the highest long-term returns over the past century[v], significantly outperforming market-cap-weighted large-company U.S. stock indexes. This combination of higher documented returns and valuations closer to historical norms makes these funds an attractive option in certain portfolios. However, it's important to note that these higher returns have historically come with increased volatility. As such, they are best suited for clients with greater risk capacity and a strong risk tolerance.

The International Stock Market

We believe we understand the challenges faced by overseas economies – a slower return to normal post-COVID, lack of market vigor in Europe, political uncertainty in South America, overcapacity and debt/worthless real estate overhang in China, competition from China's exports challenging other emerging markets, etc. Further the performance of international equities has lagged US equities for the past 16 years since the Great Recession ('07-'09) by a factor of more than 2:1 (looking at US Total Stock Market Index vs. All World Ex-US stock market index from 1/1/09-12/13/24 – tickers "VTI" for US vs. "VEU" for ex-US). That said, it is important to note that that same ex-US index has a weighted average P/E ratio at 15.23x and the dividend yield is 3.23%. In contrast, the US fund trades at 27.07x earnings and has a 1.25% div yield. Let's dig into this further.

The spread in the price-to-earnings ratio and price-to-book ratio of the US stock market vs. the INT'L Developed Market Stock Index (using the Fama/French stock indexes) now stands at a 60-year high. We would go back further, but that is our most distant common starting point for returns data. [vi] The objection to this comment is that the US has become a "tech heavier" stock market relative to the rest of the world, and this sector, given its scalability and higher profit margins, can & should command higher P/E and P/B valuations. We agree that the tech sector should trade at a higher multiple of earnings and book value than materials and financial companies which are more heavily represented in foreign stock market indexes. There is no argument on our part, here. But thanks to some research from the largest bank in the US (JP Morgan Chase), we have great ammo that suggests heavy US tech weightings alone cannot explain these skews. How? The valuation skews do not occur solely at the broad index level. Rather, abnormally high valuation discounts also exist at the industry segment level WITHIN the indexes. International technology stocks trade at a ~38% discount on a multiple of earnings, vs. a 20-year average discount of about 8% vs US tech stocks. The skew in consumer discretionary stocks is even worse with a current discount on multiples of earnings at 50% vs. a 20-year average of 28%.[vii]

Fixed Income (Bonds)

Historically, the majority of bond returns have come from their yield-to-maturity ("YTM") rather than price appreciation. This is logical, as bond coupons are contractual - guaranteed unless the issuer defaults - and holding a bond to maturity ensures the stated return (its YTM) from the purchase date. Until recently, bond investors faced limited return opportunities. Between 2009 and 2021, the 10-year Treasury yield averaged just 2.28%, never exceeding 4%.

In contrast, the current environment offers significantly higher yields, with the 10-year Treasury offering 4.60% as of this writing. While nominal yields were similarly attractive in 2022, high inflation led to negative "real yields" (nominal yields minus inflation). It was akin to swimming faster but battling an even stronger current. Today, with inflation moderating to 2.75%, real yields have turned positive. Bond investors are no longer fighting against the current - they are making meaningful progress.

Comparing an expected 10-year return of 4.6% on a 10 year treasury bond (with minimal uncertainty) against the 10-year forecasts for US stock returns in our linked outlooks from Vanguard, BlackRock, Fidelity, Schwab, and Goldman Sachs above, further supports our outlook that bonds offer a more compelling return proposition (on a risk-adjusted basis) vs. the S&P 500 at present, particularly for monies earmarked for use within the next 5, and possibly even 10 years.

For investors willing to take on slightly more risk than treasuries, but still far less than the S&P 500, corporate bonds, senior secured private debt, trust-deeded mortgage debt, etc. offer higher yields. These instruments are generally less tax-efficient than treasuries and stocks, and as a result, we view them as more appropriately allocated in tax-deferred or ROTH-style accounts.

Real Estate

The past three years have been tough for U.S. REITs, mainly driven by (a) the sharp increase in rates in 2022, (b) the regional banks' vanishing appetite for commercial loans, and (c) unprecedented office vacancy triggered by the COVID-induced spike in remote work. The Vanguard REIT Index ("VNQ") recorded a cumulative loss of approximately 13.6% as of 12/31/2024. Over the last decade, however, this index delivered an annualized return of 5.0%, outperforming bonds by more than 3.5% per year, though trailing the S&P 500's impressive 13.0% annualized return over the same period.

It's important to note that real estate investments come in many forms, with varying levels of risk, return, and investor involvement. Some approaches have performed far better than others:

1. Publicly traded real estate stocks – Ideal for those who value liquidity and a hands-off approach.
2. Private market real estate LP interests – Suitable for passive investors comfortable with sacrificing liquidity for potentially higher returns (particularly in development and lease-up plays) and/or lower volatility.
3. Direct ownership of real estate – Best for investors who prioritize full control, even at the expense of liquidity and passivity.

Each strategy presents distinct advantages and challenges, making it crucial to align your choice with your financial objectives and risk tolerance.

While public REIT indexes may offer higher return potential than more conservative private real estate plays, outsized volatility, given their high levels of leverage, are expected to persist. It's important to note, that unlike private REITs and real estate funds, publicly traded REITs like VNQ tend to be highly correlated to US stock market movement. Translation >> less diversification benefits.[viii]

Private real estate markets, on the other hand, have been proven to move almost independently of US stock markets. We advise caution when considering private real estate fund managers with limited track records or those relying heavily on significant leverage (i.e., loan-to-value rations > 50%). In today's environment, we see well-capitalized and "vertically integrated" real estate managers as holding a substantial competitive edge. With access to capital for real estate financing constrained and the demand for repurposing commercial real estate, particularly in the office sector, on the rise, these managers are better positioned to navigate and capitalize on shifting market dynamics.

Direct ownership of real estate is challenging to generalize because markets vary significantly by geography and property type. Most of our clients lack the capacity to independently enter the commercial real estate market due to its high entry costs. In the current environment, elevated borrowing costs, rising insurance and maintenance expenses, and stagnating rental rates have made single-family rental property investments less appealing.

Even under more favorable conditions, we typically do not recommend rental property investments unless a client's unique circumstances provide the flexibility to accommodate the time commitment and illiquidity associated with owning rental properties.

Alternatives

While total returns from alternative investments, such as (a) hedge funds with low beta risk, (b) precious metals, (c) private debt, and (d) commodities, have historically lagged behind equities, their role as diversification tools is well-documented. Like our approach at FFG, endowments and pension funds are typically not designed to maximize total expected returns at all costs. Instead, they aim to deliver long-term returns that significantly mitigate risk during "tail events" and enhance the likelihood of achieving target outcomes. A 2024 article in Pensions & Investments reported that, among the 708 plans in Preqin's database, the average target allocation to alternative investments was approximately 30%[ix]. At FFG, we typically do not recommend such a high allocation to alternatives, as our individual clients often have greater liquidity needs than multi-billion-dollar endowments and pension funds. However, we reference this study to underscore the value that some of the nation's largest institutional investors place on alternative investments as part of their portfolios.

Endnote References

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