

Episode 170 Investment Strategies in an Uncertain Market

Patti Brennan

Hi everybody, Welcome to the Patti Brennan show. Whether you have \$20 or 20 million, this show is for those of you who want to protect, grow and use your assets to live your very best lives. Joining me for a second round is Brad Everett. Brad is our Chief Investment Officer. Our first podcast was talking about the macro stuff. Now we're going to talk about, what are you going to do about all this stuff? Brad, welcome to the show.

Brad Everett

Hi Patti. Thank you.

Patti Brennan

Okay, so let's do a recap of last year, and I'm going to look it down at my lap and kind of recite some of the things that happened last year. So the S&P 500 was up 23% plus. NASDAQ was up 29%, the Dow was up 9. Inflation average 2.7, GDP came in at 3.1 and unemployment is still fantastic, running just at 4.2% -- so it was a really good year. And now, within that framework of the full year, let's talk about what happened in the fourth quarter. We had a Trump bump when Trump got elected, and then Jerome Powell talked, we talked a lot about that in the first first podcast, right? So for those of you who are just tuning in, tune into that one, Brad and I talked about the Federal Reserve and interest rates and what we might expect going forward and how the market reacted to the latest meeting, we talked about growth in this country and what creates GDP. What is GDP? And boy, we're doing a lot better than we thought we would be at this point in time, right? And then last but not least, we also talked about the election and some of the things that are coming out as a result of Trump being elected, and what that might mean with your money, which is really the gist of this podcast. Now, having said all of that, what are you going to do? Brad, what are we going to do with all that information?

Brad Everett

It's a great question, so I guess you know, we can go through various asset classes.

Patti Brennan

That makes sense, because you and I both know, because of what's happened with the S&P 500, everybody's like, why bother investing internationally? Why bother investing in bonds? You know, Warren Buffett says, just put your money in the S&P 500. You're good, right, right? Why don't we do that? Brad, what's the risk in doing something like that?

Brad Everett

Yeah, I guess you could just have tremendously long periods of underperformance, right? We're not, you know, we're not purely managing investments just for return. We're financial planners that are trying to manage for a goal, right? And sometimes the most promising rate of return may come in a very scary

way that actually is not appropriate for the person that's actually investing. So, you know, it really does kind of come back to, like, a more fundamental level of why we're investing in.

Patti Brennan

That is exactly the answer I was looking for, because yes, the S&P500 has done really well over the last 5 and 10 years, especially related to other countries. But we have to dissect that a little bit, right? So JPMorgan put out this guide to the markets, And what I found interesting is based on that 24 plus return in the S&p500, the mag seven, seven companies out of 500 basically were responsible for 55% of that return. So what happens when they go out of favor? What happens if they don't keep on growing, or they disappoint, right? That could really be scary.

Brad Everett

So just to even back up a little bit, you know, really the growth rate of a stock, the return on a stock, just comes down to really two basic things, right? You've got the growth in its earnings, the underlying performance of the company itself, and then how much are people willing to pay for those earnings? Right? If you are you willing to pay it. But you do, you don't only nly get the earnings that you know about that are coming right up. You also get the future earnings that are a little more vague, right? So you might be willing to pay more for a company that can grow those earnings quickly, or maybe there are also times when investors are willing to pay more for earnings that are more sure. Yeah, right?

Patti Brennan

Show me the money!

Brad Everett

Yeah. So I think that may or may not happen. You know, there's what happened last year, which is just tremendous concentration in very few stocks. They did grow earnings well, but they also are trading at multiples that at some point they may not be able to, you know, sustain. Or honor the growth rate that's kind of built into that expectation. So, you know, if you think of those two components, right, earnings, they could be good, right? I mean, I think again, just to go back to the last conversation, the economy is still, you know, fairly strong, stronger than I think everybody thought it was going to be by last year. I think, you know, going back two years, everyone had a prediction for when the recession was going to start right, and the economy is still stronger than than we thought. So if you thought earnings could be strong still, you know, where are the opportunities, where you actually thought those valuations could expand? Where would people be willing to start spending some money? And I think that's when you get into the nuance of where you want to invest.

Patti Brennan

It was interesting, because before we turned the cameras on you, we were talking about value investing and growth investing and how really performance comes from surprises. We thought something was going to happen. It turned out to be even better, and you used Nvidia as a great example of that, right?

Brad Everett

Yeah, you're sort of, it almost seems like you're handicapping horses to some extent, right? You think of an NVIDIA that's continued to just outperform estimates and outperform estimates, even though the estimates have been really high, really aggressive, right? And they beat it. And so you have the growth to the estimate, but then you have the growth past the estimate when it gets there. So you know, that has fueled you could say that they deserve to grow that much because they are earning that much, that earnings. Part of the calculation is growing very, very quickly. The other, the other part, though, is as they've been gaining steam, that valuation part of it's been gaining steam too, and those seven companies are trading at what seems like fairly expensive levels, or levels that would demand that they continue to grow at a very rapid rate to justify the price. Yeah.

Patti Brennan

I think I read in the Morgan piece, that they, on average, have PE ratios of 50, right? That's really high by standards, even for technology.

Technology usually trades higher, I just can't help but wonder the one quarter where people were expecting, I don't know, pick a number, \$300 a share, and they come in at 290 and that people are going to freak out, like, oh my goodness, what's good? What's happening with this company?

Brad Everett

Yeah, yeah. I mean, it probably would only take that right, or maybe two quarters in a row, and then you have it come down to more reasonable multiples. But yeah, I think that's the difference between, you know, growth and value is, I think value probably is significantly more predictable in terms of revenue streams, right? Like, like JP Morgan, they're not, they're not on the frontiers of a new type of business. They have interest cost and interest expense, and they try to sell credit cards, and they have, like, other ways to make money. But it's all, it's all a lot more predictable than what you know Palantir might come in with on a every three month basis,

Patti Brennan

We were talking about this, there's somebody said this, I don't know. I would love to give the person credit, but they said, Excel killed value investing because it's all math, right?

Brad Everett

Yeah, sure. It's like, everybody's got the same information, right?

Patti Brennan

Okay, so now That we've talked about that, Let's talk a little bit about the United States versus overseas. So we diversify globally, right? But that hasn't been so hot. You know, I love the way you put this before, diversification isn't the goal there isn't to get a higher return. You're probably not going to. In

fact, it's, you're, you're going to dilute your returns. So let's talk about the concept of diversification, especially as it relates to international investing.

Brad Everett

I don't think, well, I guess, to back up a little bit, I don't know that diversification has to dilute your returns. I think you want to try to get your returns in a different pattern, right. Fundamentally, you know, to go back to value versus growth. I mean, we're just in an environment now where it just really seems like growth works and nothing else does, right?

Patti Brennan

Yes

Brad Everett

But there have been periods and not very long ago that value works and nothing else does. If you actually just extend the timeframe, I thought I looked up, if you go back to like, I think it was January of 2002 all the way to the end of 2022 the difference in performance of value and growth is like 1/10 of a percent. I mean, it's very, very minimal. You just have these long stretches of outperformance of value and different kind of interest rate regimes may kind of encourage one or the other, but

Patti Brennan

Okay, let's stop there, because you also brought up another point about interest rates as it relates to valuing companies and the growth of companies value tends to outperform. I don't want to steal your thunder. That's a great point.

Brad Everett

Oh, yeah. I think it just comes down to the time value of money, right? If you at higher interest rates, \$1.10 years from now, is not worth as much to me when there are lower rates. And I think that's what happens with a non profitable, but potentially really great growth company, if interest rates are five or 6% like I really don't want to pay to wait that long for them to grow money. I'd rather, you know, invest in a company that, like Procter and Gamble, or somebody that actually makes money now, yeah, so that that can, that can matter. I guess you would have an impact between, you know, large and small cap companies too. I guess the small companies would tend to be a little more debt leading so more sensitive to borrowing costs and things like that. If rates are high, you know, they may choose to borrow less or not at all, or they'd have to be a little more selective with which products they took or projects they undertook.

Patti Brennan

Okay, so that's US. Why should we be overseas, though? Why is the United States so dominant as it relates to returns? And I keep going back, because we keep hearing about it. So why are we recommending, why are we keeping international equities in the portfolio, and what makes the United States so great, right?

Brad Everett

So you're right, it has been bad. I think, you know, if you just look over the last 10 years, the gap is pretty extreme. It's like 8% a year between the s&p and, you know, the ACWI ex-US, like, it's 13 to 5 or something like that. So it, it is significant.

Brad Everett

And there probably are structural advantages to that long term, right? There actually might be reasons why that could persist. So, you know, there's lots of things. I think part of it has just been the timing of where we're at in the economy, which, again, this is one thing that wouldn't continue forever. We've been in a very low interest rate environment for a long time, which has benefited these growth tech companies, which we just happen to have a lot more of them than other countries do. So it's a bigger weighting in our index to have Nvidia and Apple and Microsoft and things like that

Patti Brennan

eah, think about international companies. Are there many tech companies overseas?

Brad

I mean, I guess semiconductor manufacturers, yeah, I don't know that you have much in terms of software like we do. You think of like Salesforce or Adobe or things like that, are all here, and that's part of it, too. I mean, those are names that get totally forgotten, that have grown at extremely rapid rates, that's one of the things that could change, right? I think there's certain things that are going to be structural advantages forever, right? I think we probably have better universities to attract people at the right time of their life, when they're ready to get ready to work, right.

Patti Brennan

...helping with our labor force, etc. Yeah, it's in. I don't know how you're going to feel about this, but I did quote you in the prior podcast with Carrie, when you said, "yeah, the education system is actually, you know, our fourth graders are kind of dumb, but our universities are great."

Brad Everett

Yeah, I don't think the world gives us a whole lot of credit for primary schools. I don't think that's a whole lot to be overly proud of. But yeah, I think our universities are still probably pretty good. You would come here. You wouldn't come here for fifth grade, right? You would come here for college, probably with the hope that you could stay here too.

Probably, sure. So, yeah, we have deeper capital markets, right? We have a giant country that all speaks the same language. It's a unified, huge market.

Patti Brennan

That's a good point, which won't change.

Brad Everett

It's, it's extremely liquid. You know, the cost of trading is, is very low, not only the cost of trading in terms of, like, cheap, cheap cost trades, but like, the bid ask spreads are very narrow, right?

Patti Brennan

Which a lot of people don't realize, that's behind the scenes, but that's a factor in this stuff?

Brad

Sure, yeah, you wouldn't hesitate to make a trade because it's some illiquid, untraded market, right? You probably have access

Patti it feels like a different way of saying it. People trust our markets more. Yeah, they really trust. They trust they trust that whatever they want to do gets done, right? It's transparent. There are regulations. We follow the rule of rule of law, right?

Brad

Yeah, I think we have probably a more diversified market too, you know? I think if you lived in, I don't know, pick a country Hungarian.

Patti What do they do? Beer, I don't know,

Brad

Well, right? I mean, if you want to invest in tech, you just have to invest in another country, right? You just can't domicile all your wealth there. It has to be invested in the US, right? So if you want to diversify into asset classes or sectors that don't exist in your country, you have to consider another one.

Patti

It's an interesting point. I wouldn't have thought of that one. And that's that.

Brad

I mean, I think there's a culture here of innovation, probably that will last forever. I guess there are some. Things that may not last forever, though, right? And you don't, you can't just know when to switch, yeah, because, again, just with the value and the growth and the large and the small, there are huge periods of outperform, long periods of outperformance, when the international stocks, significantly outperform US stocks. And so one of them could be, you know, that period, like we just said, you know, we've enjoyed a period of low rates, and that's benefited us. That could change. I think currency is a

huge impact, too. So if you go back to that period, that same period where it was like 13 to five 2.2% of that is just from appreciation of the dollar. So that, just right off the bat, takes it from 13 to 7.2 so that's a big part of it, right? And if the dollar decreased in value, you would have it being subtractive from our returns, not additive. You know, we heard the example at an event last week of Exxon versus BP? was really the exact same company, the exact same work at the exact same business model, trading for less than half the PE multiple just because it exists in another country. Just what unlocks that value, though? What becomes the thing that says that's what we have to buy rather than Exxon? And you know, what would that catalyst be? I'd almost wonder if it's just, is it that we have -- I was just trying to, like, think of, daydream about examples of what would change that right? And is it maybe that we don't get inflation out of control, under control, and we actually have to raise rates again, our currency starts to depreciate, other currencies start to appreciate, and then capital would be attracted to other, to Europe instead...

Patti

I think it's exactly what you're leading to. It's not one thing. It's it's a domino effect. Then momentum takes off, animal spirits, and it's like, Whoa. That's where the values are. Let's sell this and move over there. And that happens on a dime, yeah,

Brad

but it also could last for a long time. Let the I mean, right now we're, we happen to be in a, you know, 13 or 14 year us stretch, right? But before that was a very long international stretch, and we could have a very long international stretch after that.

Patti

And nobody sees international outperforming the US. Nobody we have interviewed says, Hey, overweight international, US is really dicey, our debt or whatever, you know, give our give us our reasons

Brad

which means we're probably about due

Patti

well, you know, who knows? We don't know any of this, which is why we diversify. We have both?

Brad

Yeah, we have both.

Patti

You know, you also brought up an interesting point about growth companies in the US, right? So you think about what has really been the performers. It's been growth companies, but then you look at their balance sheets and go ahead and tell that story.

Brad

yeah, you know. So you try to look at you slice and dice it every which way, and say, What's cheap, you know, let's forget about what's happened. Where are we today, and what looks good going forward? And you can, you can make either argument you want, right? I think in terms of valuation, value looks great, like it just looks so cheap compared to growth.

But you know, to make the argument for growth stocks and to think that they could continue to innovate and outperform for a while .. If you look at there's really two ways to think about it, cash on balance sheets, right? Is, you know, if you divide it up by sector is dominated by growth sectors, like traditional growth sectors, you had health care and discretionary consumer spending and things like that.

Patti

So they have had the profits, and they squirrel And they've got the money.

Brad

They got a ton of cash, yeah, but you know, so maybe they don't have any good ideas, and holding cash isn't smart, but those same exact sectors are the ones that are spending the most on research and development. So you know, you'd think maybe they come up with some ideas, and they have the cash to spend it.

Patti

This is random, but it's interesting. When you think about the mag seven to your point, they are the companies that have the cash. They're the ones that are innovating, and You know, Nvidia's Nvidia. They are the only game in town, right when it comes to the chips that can produce artificial intelligence. So everybody's going to Nvidia. Well, you know what?

These management, this senior management, they're not stupid. They're saying, you know, we're really dependent on this one company, and they're charging us a lot of money for this stuff. Can we figure out a way to do it ourselves? And they're going to another company called Broadcom, and they're bringing it, they're creating the stuff in house so they're not so dependent on this one company. That's what's really cool about this whole Cycle, and people are people. And when we go through periods of adversity, people get creative. Senior management says, you know, this is really going to eat into our profit margins. We answer to Wall Street, we answer to our shareholders. What are we going to do about it? We have the money. Let's invest in this company. Let's invest in this new technology in such a way so that we're not so dependent on one company to give us these little chips to let us do it. Yeah. So it's so

interesting how decisions are made, sure. And to your point, they have money, right? But, and I think there's like, knock on, knock on effects too, like you think of, you know, you could think that AI is just going to be the rich getting richer, right? These companies that have the money to innovate, you know, will continue to innovate, and they because it's very capital intensive right to develop chat GPT. But think of the other kind of knock on effects, like I'd have to go back and review the details, but there was some sort between Microsoft and Chesapeake Energy, just a huge like, 20 year energy contract to make sure that they could power their facilities without, you know, some sort of incredible volatility in their prices. And that's a really good point, because there's going to be a domino effect. We haven't quite seen it yet, but that's why, again, to your point, we don't only want to be in tech. We don't only want to be in the S&P500 that's dominated by tech, because there are a lot of other industries and a lot of other really smart companies that will also benefit from this new wave of innovation. Yeah, right. So that's very interesting. So we've talked about different sectors, growth, value, large, small, us, International. What other things are we diversifying in that helps to kind of create that garden effect? You know, right now, as we speak, I don't know what's today. Today is the 14th we've been going through a period of a lot of volatility. Markets have been plummeting. So What? What? What do we do on putting words in your mouth right now to help right in periods like this?

Brad Everett

Yeah. So I think on the equity side, you know, Dolly Parton always says, If you want to, if you want to see the rainbow, you've got to be willing to go out in the rain. But I think if you have a shorter term time horizon, you want to look for other things outside of equities, right? I think you like equities are long term money, right? Like, that's, that's not the thing that we have in place for people that need money next week. So I think the bond market is, I think, in great shape to start right. If you held bonds three years ago, you might still be underwater, but with new investing going forward, you would probably feel like there's quite a bit of opportunity there, and let's quantify what opportunity means.

Patti

Does that mean that they could, people could get 10, 15, 20% return?

Brad

It'd be probably pretty high, I think, you know, depends on, depends on the credit quality. But you know, if you thought about high yield, I mean, I guess you could get high single digits, depending on, depending on, you know, which part of the market you picked. But no, I think you know, easiest predictor of bond returns is the yield in place when you buy it right, right? And yields are in they're pretty good, not as high as they were. But you know, I think there's opportunities for sure.

Patti

I thought it was really interesting in that panel that we interviewed not one, not two, but all seven panelists said, Oh yeah, the low hanging fruit. Those are my words, low hanging fruit, or bonds. Yeah, right. Like, that's probably a safer if you're going to bet that would be the safer bet, yeah, going forward from here, yeah. So I think you could my takeaway from that.

Brad Everett

I think you could believe that stocks will perform better, but if you were just thinking in terms of risk adjusted return, right return per unit of volatility, bonds might be appealing. Like, if you, if you thought, okay, earnings are going to be strong with equities, but maybe P multiples contract, you might think that equities aren't going to be at 12, 13% they might be at seven or eight or nine, right? So, like the lower end. So why bother going through all that pain? Well, right? If you really believe that seven was it, but you could get five or five and a half with a bond, well, you're not going to keep up with the stocks. And if it's long term money, one and a half percent a year is a lot. But if it's shorter term money, and bonds are, bonds are really appealing.

Patti

that's a really good point, right there, because most people, don't live in the long term, right? They live in the short term. They watch the headlines, yeah. And so we're talking about positioning and what to do, and it is really important to keep in mind that we're we're talking short, intermediate and long term, because that's really how you grow wealth. You want to stack on top of the wealth that you've already saved and invested. So I think that to pull all this together, diversification is still there. It is still a really important tool to use to protect and grow assets, right? And we're never going to know what's going to be the big performer. We just don't know. We don't know what's going to happen with these mag seven stocks. They could continue doing what they're doing, or they could miss an earnings and plummet.

I mean, you're too young for this, but you only have to live through one of those periods of time to know you never want to go through it again. When we went through the.com bubble and the crash, and people who believed in these companies that they were investing in, so believe them, knew that they were great companies and they were and they still lost 80% of their money, and there it was not coming back. That's really painful. You never, ever want to get there, yeah, and most people don't need to, right? So we diversify. We don't get too cute. Be everywhere all the time, and you'll do fine, yeah. How's that sound to you?

Brad

Perfect.

Patti

All right, good deal. And thank you so much for joining us today. That is the message. We don't know what's going to happen in the future. Be everywhere all the time. You'll do terrific. If you have any questions, go on our website, www.keyfinancialinc.com, take care of yourselves. Bye. Bye.

