Second Quarter 2024
Investor Letter

Market Review

Financial markets performed well again in the second quarter of 2024. The S&P 500 Index rose 4.3% during the period and the NASDAQ Composite rose 8.5%. The Bloomberg Aggregate Bond Index rose .1% for the period. The quarter began with correction of 5.4% in the S&P 500 and 6.7% for the NASDAQ, which at that time was attributed to higher-than-expected inflation and the prospect of a "higher for longer" interest rate policy by the Fed. Since then, the inflationary outlook has improved, and equity markets have staged a strong recovery. From the low on April 19, the S&P 500 rose 10.2% and the NASDAQ rose 16.2% by the end of the quarter. Investors who overreacted to the macroeconomic headlines in April were reminded once again of how detrimental such behavior can be to their long-term returns.

The current rally has been led by stocks which stand to benefit from recent innovations in artificial intelligence. The increase in price has led to talk about a "bubble" in AI stocks, along with predictions of a significant decline. While a significant decline is certainly possible after any significant increase in stock prices, investors would do well to keep the following points in mind. First, virtually every stock market rally is characterized by a divergence in stock performance. In an economy as dynamic as the US, it is perfectly normal to have some companies growing and others stagnant or detracting. So, the narrow market leadership is not unusual. Second, in the case of the development of a new technology such as AI, it is to be expected that there will numerous cycles of exuberance and setbacks. Third, it is very possible that the overall market rally will broaden out to include more companies and industries, especially if inflation and interest rates continue to fall.

The development of any new technology is highly uncertain in its initial stages. In addition to uncertainty about whether a technology will work, there are always significant questions about how a technology will impact the economy. The use of new technologies has varied substantially over time. Some new technologies are used primarily for reducing costs (think manufacturing or robotics). Others are used for safety (airbags, antilock brakes). Some are used to improve the consumer experience (flat screen televisions), while others create entire new industries (air travel, social media). It isn't knowable in the early stages what benefits will come from a technology as significant as AI.

Impact of the Election on Financial Markets

Investors often feel that their investments are more at-risk during election years. This is understandable since elections tend to dominate the headlines, with both sides predicting doom if the other side wins. What actually happens to the market during election years? Data on the past 10 presidential election years shows that the market has risen in eight of them, which is the same ratio as for non-election years.

There is some evidence that market volatility is slightly higher in election years than in non-election years. (Interestingly, research shows that the third year of the presidential election cycle is usually the best year for the market.) Our advice is to not make investment decisions based on who may win or lose the election this fall.

More on Stock Market Valuation in the New Economy

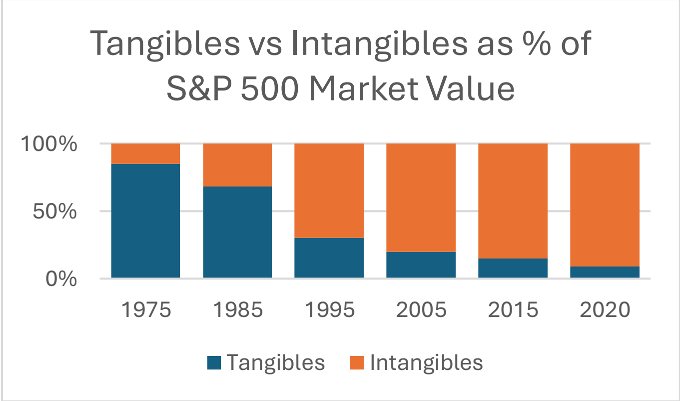
In our First Quarter 2024 Investor Letter we noted that some measures of the US equity market showed it to be substantially over valued, while others showed it to be around fair value. In this Letter we will go into some additional detail to explain this apparent paradox.

Broadly speaking, analysts seeking to measure the level of the market relative to earnings use one of two methods. The first is to add up the earnings of all the companies in an index (say the S&P 500), weight them using the methodology of the index, and compare that number to the level of the index. So, for example, if the total earnings of the S&P 500 are $200 per share and the level of the S&P index is 4,000, then the market could be said to be selling at 20 times earnings. The analyst compares that figure to other periods and makes a determination of whether the market is under or overvalued.

Another method of getting to a valuation of the market is to independently value each company in the index and compare that valuation to the market price. This method requires substantially more work. Calculating fair value this way requires employing analysts who specialize in different industries, and who can understand the fundamentals of each company, make forecasts of their earnings potential and cash flow generating ability, and arrive at a valuation. When this analysis has been done for each member of the index, the results are aggregated in order to arrive at an estimated fair value for the index.

Thinking back to the original paradox, how can it be that the market sells on a higher-than-normal P/E ratio, but doesn't appear overvalued based on individual company analyses? The most likely explanation is that the underlying components of the index have evolved over time towards companies which merit a higher earnings multiple, resulting in an upwards shift in the fair value of the market based on current earnings. In other words, the components of the S&P 500 contain more companies which would be expected to sell at high valuations and simultaneously fewer ones which sell at low multiples. The following charts illustrate some reasons this is the case:

Chart 1
Ratio of Tangible Assets to Total Assets
(courtesy of Sands Capital Management, 2024)



As the chart demonstrates, fifty years ago almost all of the assets of American companies were what accountants call "tangible assets." Think property, plant, equipment, etc. Today tangible assets make up just a small portion of the assets on which companies earn their returns. One important reason this change matters is that, while tangible assets depreciate and require constant reinvestment, intangible assets do not, and so cash flow can be invested in expansion, dividends, or share repurchases. In addition, because tangible assets are depreciated (which reduces earnings) while intangible assets are not, it can be argued that earnings of modern companies are understated relative to in the past. In other words, a given level of earnings of a modern company requires less ongoing investment than a company of 50 years ago. Warren Buffett was one of the first to write about this insight, and it explains many of his early investments in relatively asset-light industries, such as television stations, trading stamp companies and candy manufacturers. All things being equal, companies which are less capital intensive will earn higher returns and sell at higher multiples.

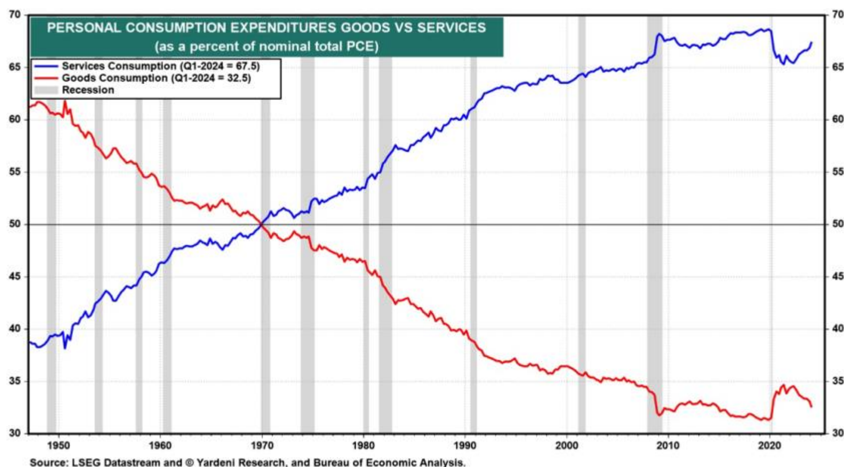
Reduced cyclicality is also an important factor in higher valuations. When a company's earnings are highly cyclical investors will generally put less value on current earnings, since they will expect that even if earnings are good this year, there will probably be a downturn sometime in the next few years. Contrast that growth pattern with a company whose earnings tend to grow steadily over many years. Investors will usually assign a higher multiple to such earnings since when they anticipate a steadily growing earnings stream. The following chart shows how the operating margins (and therefore earnings) of US companies have become much less volatile in recent decades:

Chart 2
Standard deviation of margins of S&P 500 Companies
(courtesy of Sands Capital Management, 2024)

Why have earnings become less cyclical? An important explanation may be that the makeup of the economy has changed dramatically in recent decades. The chart below shows the evolution of the US economy from goods to services. As can be seen, consumption of services surpassed consumption of goods around 1970 and has steadily increased ever since. Note that beginning about 12 years after this

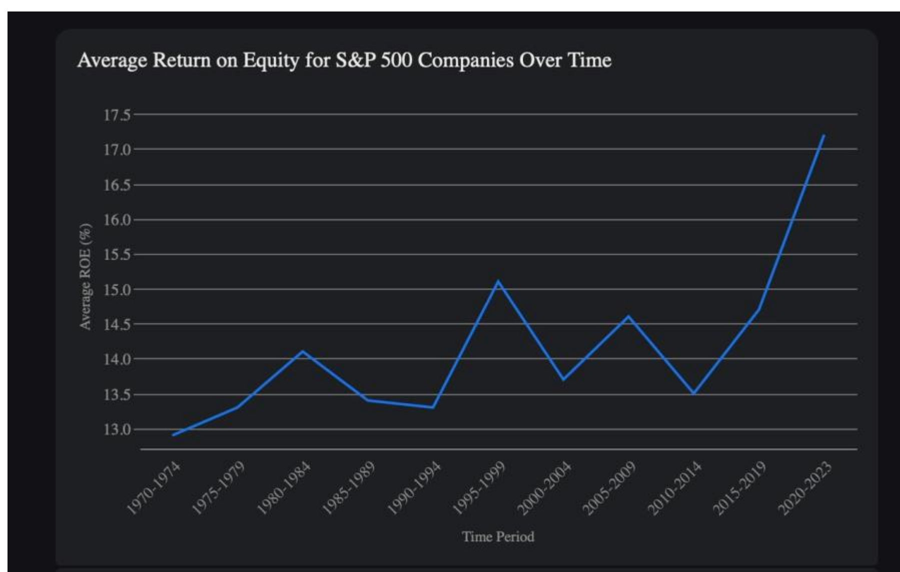
(around 1982), the economy became much less cyclical than it had been previously (recessions are indicated by the shaded areas in the chart.) A reasonable explanation for this change is that consumption of services tends to be less cyclical than consumption of goods.

Chart 3
Consumption Expenditures: Goods vs Services



The final chart below shows one other factor which has contributed to higher company valuations—return on invested capital. As Warren Buffett and others have pointed out over the years, the best investments have the ability not only to grow, but to reinvest capital at high rates which results in further growth for many years. Capital which cannot be reinvested at high rates should be returned to shareholders in the form of either dividend or share repurchases. The chart below shows that American companies as a group are earning much higher returns on invested capital than they did in earlier years.

Chart 4
Average Return on Equity



There are other factors as well which may help explain the higher share valuations observed in recent years, but these are among the most important. A very important caveat to add to this analysis is that, just because companies are deserving of a higher multiple than in the past, it doesn't mean that they can't become overpriced. *Human nature hasn't changed*. The same principles of under and over valuation continue to apply in this era, with the difference being that the median valuation level is somewhat higher.

Thank you as always for being a client.

Best regards,

William R. Andersen, CFA
Principal and Chief Investment Officer