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INVESTMENT MANAGEMENT

PORTFOLIO INSIGHTS

October 2024: Volume 23, Issue 4 // David Ott, Editor

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Acropolis was born from a simple idea:

In an industry where high quality, objective advice is hard to come by, we make a difference by putting the client's interests above our own.

FED USHERS IN NEW ERA (OF RETURNS)

The S&P 500 enjoyed another great quarter, and unlike the first half of the year, the gains were distributed more broadly across more companies.

In the first half of the year, the average stock in the S&P 500 gained 5.0 percent, but the index rose by 15.3 percent because the Magnificant 7 gained a whopping 37.0 percent.

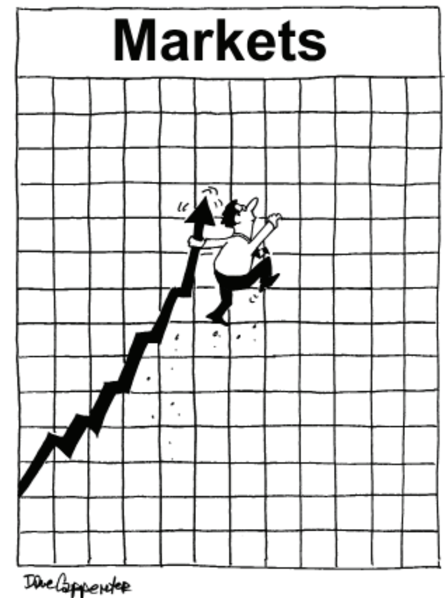
In the third quarter, the average stock gained 9.5 percent, while the Mag 7 rose 5.4 percent, and the overall index rose 5.9 percent.

The rally expanded as investors increasingly expected a soft economic landing, the Fed adopted a dovish stance, and the bond market began pricing in several interest rate cuts in relatively short order.

Corporate earnings remained strong, with S&P 500 companies reporting 11.3 percent year-over-year earnings growth in Q2, the highest since Q4 2021.

Notable themes in earnings calls included AI investment, cost-cutting, added operational efficiency, China's economic weakness, and slowing travel demand.

Despite the solid returns and positive momentum, it's still essential to remember that the US market is unusually expensive, and even though markets are expecting a soft landing, the economy is cooling.



The world is also vulnerable today, given the heightened geopolitical risks. In addition to the hot wars in Ukraine and Israel, there is a risk of escalation in both theaters, perhaps more so in a regional Middle Eastern war.

It wouldn't be surprising to see significant terror attacks, including cyberattacks. The faulty software upgrade by CrowdStrike in July is a good reminder of how much we rely on computers in our daily lives and vital areas of the global economy like banks, hospitals, and airports.

Risk is an inherent part of investing - without it, investors couldn't earn more than the yield on t-bills. Everyone knows risk is part of the equation, but it's easy to forget when times are so good for this long.

> "People generally see what they look for, and hear what they listen for."
>
> *Harper Lee*
> *American Author*
> *1926 - 2016*

STOCK MARKET SUMMARY

By David Ott

Stocks had a strong quarter, especially considering that the S&P 500 nearly had a correction, falling almost ten percent in late July and early August.

The selloff was triggered by a fast unwinding of a popular hedge fund strategy that involves borrowing money in Japan, where interest rates are low, and investing in bonds around the world with higher rates, from the US to Mexico.

That strategy, known as 'the carry trade,' works well when currency values are stable. For unknown reasons, the Japanese yen sold off by more than 10 percent over two weeks, which caused Japanese stocks to fall sharply.

Although everything came back into place relatively quickly, it's a good reminder that markets can change rapidly for reasons that aren't easy to explain and that markets are highly connected to each other, whether it's stocks, bonds, currencies, or commodities.

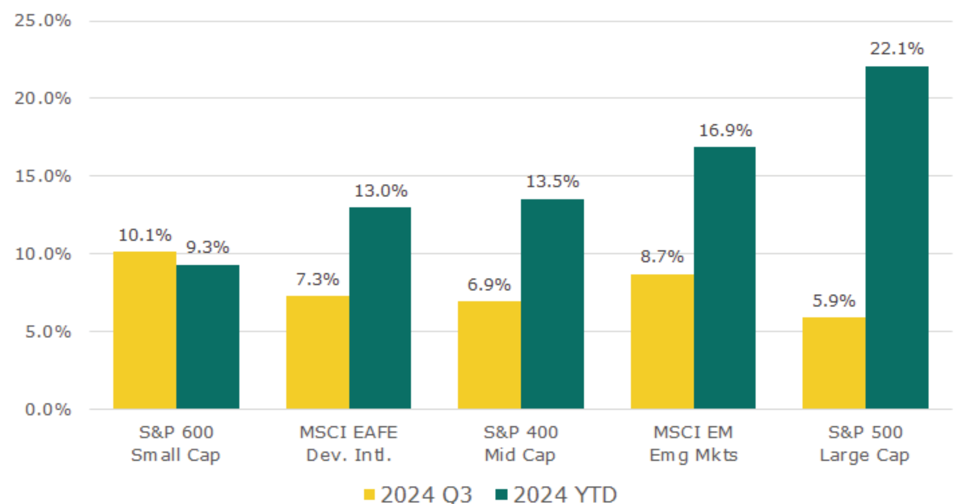
Thankfully, problems often go away as quickly as they arise, as this one did.

The other interesting story of note is the powerful rally in small-cap stocks.

For most of the asset classes shown in the chart below, the good results in the third quarter added to strong results in the first half of the year. That wasn't true for small-cap stocks, which were down year-to-date through June but are now up for the year thanks to the 10.1 percent rally in the third quarter.

Based on data from Bloomberg, small-cap stocks have been relatively inexpensive compared to large-cap stocks since late 2021. Over the last 25 years, the average forward price-earnings (PE) ratio of the S&P 600 small-cap index has been 13 percent higher than the S&P 500 large-cap index.

Small-cap stocks had traded at a premium since 2003 but fell back to a discount in 2021. At the end of the second quarter, the forward PE ratio for the small-cap index was 16.8 versus its 25-year average of 19.8, but it ended the quarter at 19.4. The S&P 500, by contrast, had an average PE ratio of 18.0 during that time and ended the quarter with a PE ratio of 24.3.



Data Source: Bloomberg

BOND MARKET REVIEW

By Ryan Craft, CFA

The third quarter ushered in a sea change for bond markets as interest rates fell 50-100 basis points across the curve.

The Bloomberg Aggregate Index posted a total return of +5.2 percent for the quarter. While all bonds participated in the big rally, the Corporate bond sector led the way with a gain of +5.7 percent. After a lackluster first half of the year, bonds caught a bid in July as equities experienced a bit of volatility.

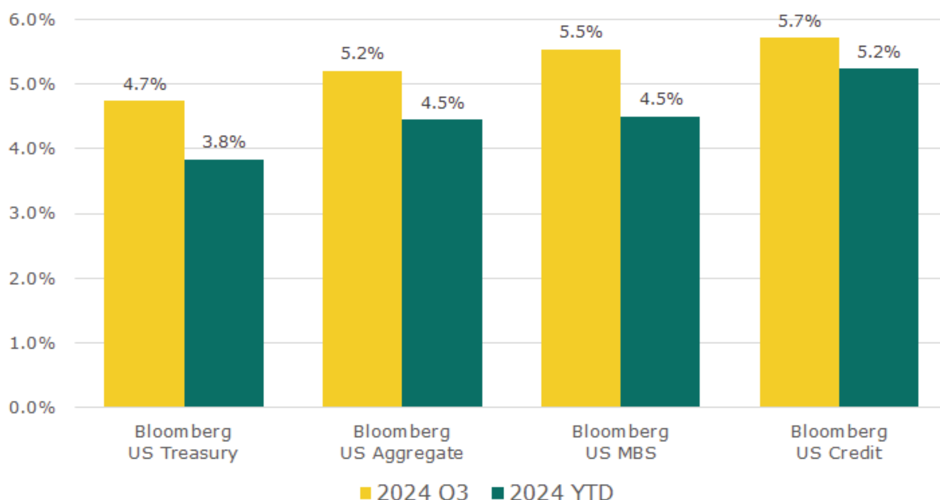
In September, the Federal Reserve ushered in a new era by lowering the overnight Fed Funds rate by a surprising 50 basis points. The Fed held short of declaring victory over inflation but acknowledged that it is no longer its primary concern. It believes inflation is on a good path back to its two percent target.

The Fed is, however, concerned that interest rates are now overly restrictive and could harm employment if held at current levels. The intention is to bring overnight rates down to a more neutral level that neither promotes nor restricts growth. By cutting rates now, they hope to avoid driving the economy into a recession by holding monetary policy too restrictive for too long.

Markets loved this new message. This change in the policy direction was well-telegraphed, even if the market was unsure of the size of the first cut. This caused equity and fixed-income markets to rally big into the outlook of easier monetary policy.

As seen through forward interest rate contracts, bond markets have priced in aggressive easing over the next year, with current expectations for a three percent Fed Funds rate at the end of 2025. This aggressive outlook filtered into bonds across the yield curve, pushing yields down at every maturity.

The market is pricing out the Goldilocks scenario that is coming to fruition. The Fed is trying to engineer a soft landing, where they can return inflation to the target rate without inducing a recession. Both equity and fixed-income markets are pricing this as a base case for 2025. Investors will continue to focus on inflation and employment data to confirm we are on this path.



Data Source: Bloomberg

"Time brings all things to pass."

Aeschylus
Greek Playwright
525 BC - 456 BC

TECH VS. THE WORLD

By David Ott

In one of our Investment Committee meetings last quarter, Minjung Son shared a report showing that the total market value of all emerging market stocks was about $10 trillion. Ryan Craft chuckled and said that was about equal to the three largest stocks in the US.

Although I've written about how concentrated the US market is and how emerging markets haven't done all that well in recent years, I was amazed that three stocks could be worth as much as all the stocks from China, Taiwan, India, Brazil, South Korea, and another dozen countries.

The chart below shows the 20 countries and companies worth more than $1 trillion (excluding the US stock market, which is worth almost $60 trillion).

As you can see from the chart below, the next largest stock market is China, although much of it isn't available for purchase to non-Chinese investors. The next largest market is Japan, which is about 40 percent smaller than China's.

Two more countries are listed, but then, in yellow, you can see the world's largest stock.

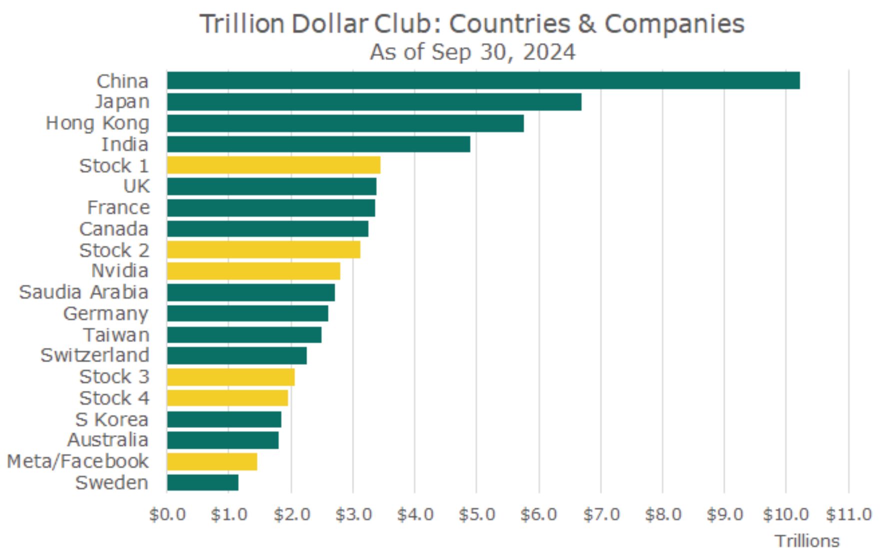
Unfortunately, I can't list all of the names of the individual stocks for regulatory reasons because they are on our Approved List. However, you can see that the third largest stock in the world is Nvidia, which is slightly bigger than all of the stocks in Saudi Arabia or Germany.

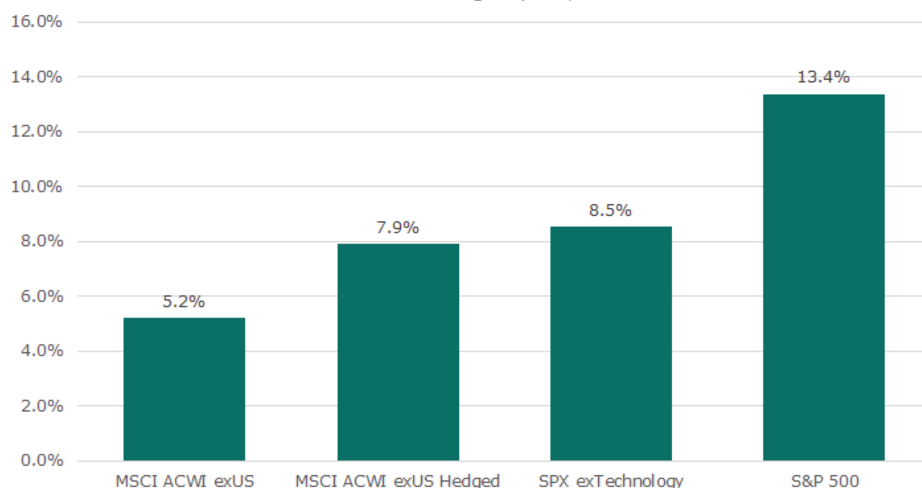
We're deep into technicalities here, but Saudi Arabia is home to the world's largest company, Aramco, their state-owned oil company. It's worth $6.5 trillion, but because it's 70 percent owned by the Saudi government, it doesn't appear in much data since the index companies remove the shares that structurally don't trade.

The sheer size of the small number of US companies shown in the chart below compared to whole countries got me thinking about the incredible difference between US and non-US market returns over the last 10-15 years, as seen on the chart on the next page.

"He who awaits much can expect little."

Gabriel Garcia Marquez
Columbian Writer
1927 - 2014





The column on the far left shows the return for the last ten years of the MSCI All Country World Index, minus the US (or ACWI exUS). That hardly rolls off the tongue, but it captures all tradable stocks outside the US, developed and emerging. Over the last decade, it's earned a paltry 5.2 percent in US dollar terms.

That last part of the sentence, "in US dollar terms," is pretty important because it tells you the returns that US investors have earned based partly on the return of stocks but also on the change in the value of the dollar versus all of the other currencies represented by the rest of the world.

The second column is the same index, but the currency exposure is hedged, which removes the impact of the US dollar, which has been very strong over the last ten years. In fact, it's been so strong that it costs US investors like us 2.7 percent per year in returns. If we'd hedged the currency risk, the ACWI exUS would have earned 7.9 percent.

So now we can say that foreign stocks have done reasonably well, but we haven't enjoyed those returns due to currency movements.

The third column shows the return of the S&P 500 minus the return of technology stocks. By comparing this column to the S&P 500 on the far right, we can see that tech stocks alone are responsible for 4.9 percentage points of the S&P 500's 13.4 percent per year return. Mamma mia!

Although this isn't a precise attribution, I think it reasonably explains the massive return differential of about eight percent per year between US and foreign stocks in round terms. Almost half of the difference is due to US tech stocks, and most of the rest is due to the strong dollar. About 0.6 percent per year isn't explained by these two factors.

I've made several arguments about the benefit of keeping a globally diversified portfolio, even though it hasn't felt like it over the last 10-15 years. The question is the repeatability of what just happened. Can tech stocks outperform by that magnitude again? Can the dollar whip everyone else again? Yes, but how much do you want to bet on that?

"It is not certain that everything is uncertain."

Blaise Pascal
French Mathematician
1623 - 1662

INSIDE THE ECONOMY: EARNINGS

By: David Ott

For all the talk about artificial intelligence, the Federal Reserve, and geopolitical risks, markets are still driven by earnings. Those topics impact earnings, which is why they get so much attention, but paying attention to the profits themselves is worthwhile.

Ryan Craft, CFA, produces a chartbook of economic and fundamental data he sends each month. If you want to get on the distribution list, email him at rc@acrinv.com, and he can set you up.

The monthly pack includes the chart below, which shows the realized earnings per share for the S&P 500 on the x-axis. The realized earnings in yellow have been relatively flat over this period, but analysts are showing a pickup in earnings for the rest of this year, next year, and 2026, as shown in the dotted orange line.

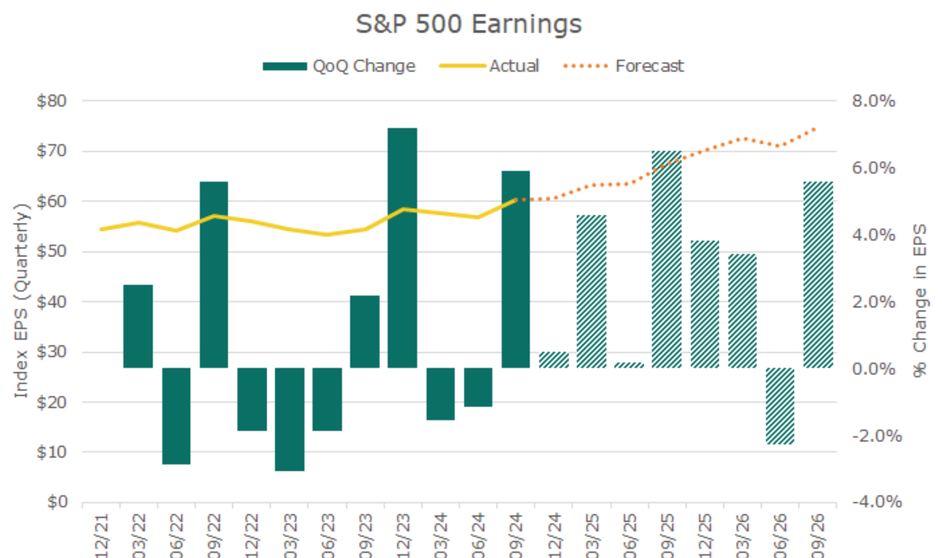
The right-hand x-axis shows the quarterly change in earnings, and you can see how volatile earnings are from quarter to quarter. Of the eight realized periods shown in the solid green, only five were positive, and the other six were negative. The good news is that the magnitude of the upswings offset the frequency of the downswings during this time frame.

The forecasted earnings, shown in the shaded green, are more upbeat (as estimates often are). Of the eight quarters shown, all but one are positive, and the average forecast is relatively high compared to the recent past.

As news unfolds, whether about AI, the Fed, war, or any topic that matters to the bottom line, market prices will adjust because investors start to factor in how those events will impact profitability. Lower interest rates will increase profits as interest expenses fall, AI might allow for higher sales or lower costs, and global conflict will reduce demand for most goods and services, hurting revenue.

Right now, the outlook is rosy, which we can see in earnings estimates and market prices.

> **"If you really look closely, most overnight successes took a long time."**
>
> *Steve Jobs*
> *Founder, Apple*
> *1955 - 2011*



Data Source: Bloomberg

OPTIMIZATION OVERLOAD

By: David Ott

For all of the talk of artificial intelligence, when we launched Acropolis over 22 years ago, I thought understanding optimizations would be the key to our success. If we could just figure out "the" optimal allocation, we would be well ahead of everyone else.

Of course, that's true, but figuring out "the" optimal allocation wasn't possible because you can't tell in advance.

My memory (which could be better) is that our software package suggested a stock portfolio with 60 percent US large-cap value and 40 percent emerging markets stocks.

With the benefit of hindsight, I can say that the optimal portfolio didn't turn out very well: large-cap value underperformed large-cap growth, and emerging markets underperformed all other major equity asset classes.

But we didn't have the benefit of hindsight back then and still realized that the optimal portfolio wasn't optimal. We knew it wasn't diversified enough because it had no exposure to US mid- and small-cap or developed international markets.

We used optimization results to tilt our investments towards value over growth and include emerging markets, which we might have excluded.

I didn't fully understand then that the optimization is telling you something pretty simple: buy the asset classes with the highest realized returns and the lowest correlation to each other, which will lower the volatility.

Knowing the asset classes with the highest realized returns doesn't tell you much about what they will return in the future. Furthermore, the correlations change all the time. Worse for diversification, the correlations are all structurally higher now than 20 years ago.

You can run optimizers with your estimates of future returns, but no matter how confident you feel, those estimates are fuzzy at best.

With the benefit of hindsight, I can see that the optimal portfolio was 63 percent large-cap growth, 28 percent large-cap value, and nine percent US mid-cap stocks.

There are a few problems with that last paragraph, though.

First, I'm not using much data – I've got a free kick-butt optimizer online (which is remarkable given what we paid for it 20 years ago), but the data only goes back to 1995. One major lesson about optimizers is that the output is incredibly sensitive to the inputs.

Second, and far more importantly, that only tells us what was optimal in the past. It still says nothing about what will be optimal in the future. Perhaps large-cap growth will continue to dominate because of artificial intelligence. Perhaps not. We don't know, and an optimizer can't tell us.

I last used optimizers for allocation decisions more than a decade ago, although I play around with them online all the time. However, I now optimize on something Jack Bogle, the founder of Vanguard, said: the optimal portfolio is the one you can live with.

That's what I do for myself and what we at Acropolis do for all our clients. And there's no software for that.

"There is another life that I might have had, but I am having this one."

Kazuo Ishiguro
British Novelist
1954 -

Major Indexes	2024 YTD
Dow Jones	13.9%
S&P 500	22.1%
S&P 400 Mid-Cap	21.4%
S&P 600 Small-Cap	9.3%
MSCI EAFE (Intl)	13.0%
MSCI Emerging Mkt	16.9%

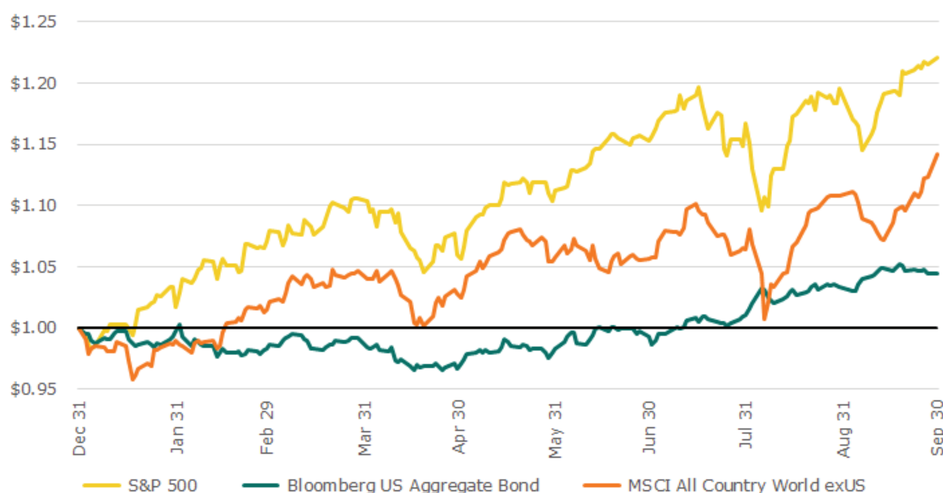
Equity Styles	2024 YTD
S&P 500 Growth	28.1%
S&P 500 Value	15.4%
S&P 500 Quality	25.8%
S&P 500 Momentum	39.1%

S&P Sectors	2024 YTD
Basic Materials	14.1%
Communications	24.7%
Consumer Discretion.	13.9%
Consumer Staples	18.7%
Energy	8.4%
Financials	21.9%
Healthcare	14.4%
Industrials	20.2%
REITs	14.3%
Technology	30.3%
Utilities	30.6%

Interest Rates	2024 Q3
Fed Funds	5.0%
Prime Rate	8.0%
3-mo. Treasuries	4.6%
2-yr. Treasuries	3.6%
5-yr. Treasuries	3.6%
10-yr. Treasuries	3.8%

All Data as of 09/30/24

THE BIG PICTURE



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