HILLTOP BANK
Trust and Wealth Management

QUARTERLY MARKET INSIGHTS – FOURTH QUARTER 2024

To the Clients and Friends of Hilltop Bank Trust and Wealth Management:

Recently, a friend described to me a theory on why the passage of time seems to accelerate as we age. As he put it, when we are five, one year makes up twenty percent of our entire lives, and unless you were a baby with precocious memory, even less of our consciousness. That is a large proportion of everything we have yet experienced. By the time we reach our twenties, that same span of time makes up less than five percent. For those lucky enough to reach their eighties and beyond, it will quickly be nearing the lower bound. As our frame of reference grows, each individual unit seems less significant.

In many, if not most aspects of our lives, this ever-quickening passage of time may tend to induce something like existential dread. There is one arena, which I have the fortunate job of reminding us of, where it is entirely helpful so long as you allow it to be. The arena of compound interest.

For example, after compounding, a dollar invested in the S&P 500 over the last five years has nearly doubled in value. That's because the market has achieved an outstanding return of 14.52% annualized over that period. Go back even further, and over the last twenty years, a dollar invested has risen over 7x in value, at a compound annualized return of 10.35%.

That return is even more remarkable when you consider the drawdowns we have experienced during that twenty year period. For example, it includes a drawdown of 50% during the Great Financial Crisis, a 20% drawdown during the pandemic, and another 20% drawdown just a couple short years ago.

As we enter 2025, it is a great time to be reminded not only of the power of compound interest but also, that if there's any upside to the quickening passage of time - it is that allowing compounding to do its job becomes easier the longer we do it. The reason I'm reminding us now, has much to with valuations in the US equity market.

As I always like to remind folks, when you purchase an equity stake in a company, the thing that you are purchasing is an economic interest in the future cash flows of that company. This is true whether it's an LLC started by a friend or a major multinational. When making such a purchase, one aspect of the investment decision ought to be what the future prospects are for the company. Does it have a strong balance sheet and growing earnings? Does it have valuable assets or a strong culture? All of these (and plenty more) should obviously factor into the investment decision.

The other side of the coin, however, ought to be how much you should be willing to pay for that stake. This consideration is not entirely independent from the company's prospects, but the combination goes to the difference between good companies and good investments. No matter how strong the future looks for a company, there is certainly a price high enough to mean you overpaid.

The simplest way to conceptualize this balancing act is the price-to-earnings (P/E) ratio. That is, the price you pay to buy the stake, divided by the earnings of the company. For example, if your friend's business earned $100,000 per year and you paid $10,000 for a 10% stake Your P/E ratio of 1.0 ($10,000 investment for $10,000 worth of earnings) is a very good deal. You would make your initial investment back in just one year.

Just as we can analyze whether an individual company is a good investment, we can do so for the entire market. One way to do this, derived by the Yale economist Robert Shiller, is to look at the current price of the entire market and divide it by its earnings. Professor Shiller prefers a ten-year smoothed average of earnings, based on his analysis that it will even out the bumps over an economic cycle. He calls this the Cyclically-Adjusted Price to Earnings (CAPE) ratio.

Over the last thirty years, the average CAPE ratio has been about 26.5. As you would assume for a figure that incorporates current market prices, it has spent very little of that period at its average. It has been constantly fluctuating from a high of about 43 during the dot-com bubble to a low of about 13.5 during the depths of the great financial crisis. With that caveat, I will report that the current CAPE ratio is currently about 38. Not quite dot-com bubble severe, but it has only been higher one other time since then, which was in 2021.

In short, that means markets are expensive. Collectively, we are currently paying a lot for the level of earnings we're receiving.

There are, of course, various arguments put forward as to why the figure is so high now. These range from the productivity-enhancing prospects of AI to the relative strength of the US economy. Personally, my ears tend to perk up whenever they hear anything close to a variation on "this time is different". It never is – history may not repeat exactly, but I tend to think it rhymes.

While I find current valuations concerning, one thing I do know is that it doesn't guarantee a crash is just around the bend.

Take an example from one of the most famous bubbles of all time. During the dotcom bubble of the late 1990s, The CAPE ratio surpassed the previous all-time high, set just before the Great Depression, in July of 1997. While we know in hindsight that it was indeed a bubble, from that point forward, the S&P 500 continued to advance for another two years, returning 53% before it eventually bust. Even at the bottom of the drawdown, in 2002, the broad market remained over 10% higher than it had been in the summer of '97 when reasonable investors would have called it overpriced.

Indeed, study after study has shown that valuation ratios (including CAPE) are essentially useless in trying to time the market. That is, while they can help us set long-term return expectations (10+ years), they say very little about what the market might do from month to month or quarter to quarter. In technical terms, these valuation ratios do not exhibit negative serial correlation or what we call mean-reversion. More simply, a high ratio today does not mean that the ratio will be lower one year from now (or even two, as in the dotcom example). It can stay high (or grow) for years to come.

Further, as we have discussed in the past, a disproportionate amount of long-term earnings happen over just a few days in any given period. For example, if you missed out on just the market's ten best days over the past twenty years, your returns would be cut in half over that period. What's more, these days often come in close succession to the worst days. Seven of those best days happened within about two weeks of the ten worst days. Even if you exited at the exact top, it would take another impossible dose of prescience to accurately time the reentry.

So, if we know markets are expensive to the point of being overpriced, but we hold no illusions that we can use that information to time the market in 2025, why have I gone to the trouble of bringing it to your attention?

Well, my hope is to inoculate us from some of the worst tendencies of human behavior, and my goal is twofold.

First, knowing valuations are already high, I hope to dissuade you from chasing prices ever-higher. From leveraged funds to cryptocurrencies, to social media-driven pump-and-dump schemes, it seems like there are increasing opportunities to make bad financial decisions based on what some other investor claims they have made in some recent period. Remember, what you want to invest in are future cash flows at a reasonable price, not the prospect of selling something useless, at a higher price, to the greater fool down the road. While the broad market survived the dotcom bubble, the story is different for the most speculative investments of that era. Invest, don't gamble.

Second, knowing that valuations are currently stretched, we can similarly prepare ourselves mentally and emotionally for a correction, and by doing so avoid the suboptimal decision-making that will tempt us if that time comes. Specifically, the temptation to exit markets after selloffs have already occurred. By framing the issue in our minds in terms of valuation, we can see that a selloff is no different from a sale on any other item we might spend money on. We can invest at a discount.

Taken together, the old adage from Warren Buffet in his 1986 letter to shareholders rings true, "be fearful when others are greedy, and greedy when others are fearful". While valuations are just one metric, they suggest we are closer to the former, and while they can stay that way for years, thinking about their impact now can help us avoid turning market fluctuations into investment mistakes. Instead, you and I can simply rely on the quickening passage of time, and compound interest, to deliver us to our goals.

Best,

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