Knightsbridge
WEALTH MANAGEMENT

January 15th, 2025

<u>Winter Quarterly Commentary</u>

"In my opinion, you have to be wildly optimistic to believe that corporate profits as a percent of GDP can, for any sustained period, hold much above 6%. One thing keeping the percentage down will be competition, which is alive and well."

Warren Buffett in November 1999
Investor & CEO, Berkshire Hathaway

It is rare to encounter a financial letter that takes a clear position and has solid, tangible takeaways. We're going to break that mold. <u>This letter will focus on a timely and (in our opinion) advisable action we are taking right now: moving assets from the stock market into private lending investments.</u>

The S&P 500 Index just delivered back-to-back 20%+ annual returns. This has happened approximately four times in the last 100 years: crawling out of the Great Depression, '55-'56, and, most notably, in the run up to the 1929 and dotcom market crashes[1]. The recent ascent means U.S. equities have reached frothy valuation levels we last navigated in the 1990s. From this lofty perch, we are worried that equity markets could

[1] In the late 90's, the market incredibly returned over 20% for five years straight before it all fell apart.

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have substandard returns, perhaps dramatically so. Many indicators point toward lower single digit returns over longer periods.

Importantly given this negative backdrop, we believe we have a good alternative for client assets: private lending funds that should offer higher single digit returns at reasonable risk.

No one, including us, knows for sure what the stock market will do going forward. We cannot regularly time the market, and most of the time, the best thing to do is nothing. However, every once in a great while we think the odds favor a substantial realignment of assets. We believe this is one of those times.

If you are a client, there's a very good chance we've already talked to you about private lending exposure. If we haven't talked to you yet, read on, and, if it makes sense to you, call us to discuss the prospect of taking similar action in your portfolio. If private market 'alternatives' are not appropriate for you, we have other fixed income instruments we can recommend. The rest of this letter will make a brief case for this course of action.

Before we dive into the rationale behind our investment repositioning, it is worth taking a moment to be clear about what our new course does *not* mean:

- **It does *not* mean we are predicting a stock market crash. A long market stagnation would also represent an undesirable outcome for equity investors.**

- **It does *not* mean that we think the stock market will decline in 2025. There are some parallels between the current investment environment and the dotcom bubble[2]. If that analogy holds, then today is probably 1998 and buckle up, because the market rocketed higher for two plus more years before crashing back to earth.**

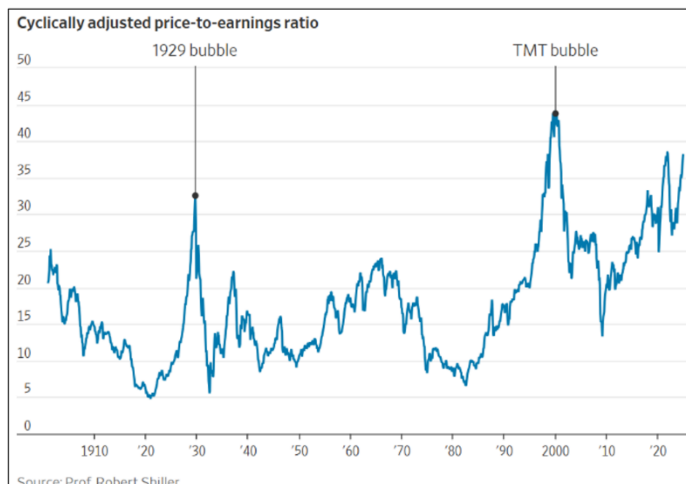
- **It does *not* mean that our chosen investment alternatives will necessarily outperform the stock market in the near term. It does mean we think there is a reasonable chance we'll outperform in the longer term without having to worry about the stock market's worst-case scenarios.**

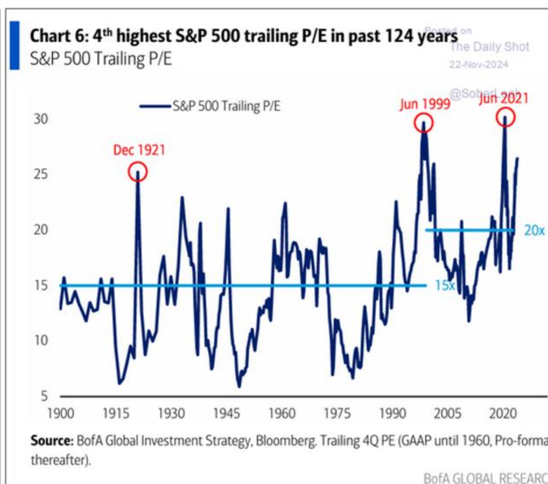
- **It does *not* mean that we are selling *all* our stocks or recommending you do so. We would almost never recommend anyone be completely out of the stock market, especially when selling would require realizing substantial taxable gains.**

Now that we've ruled out what we don't mean, lets reassert what we do mean: given our cautious outlook, we are happy to take some of our

[2] There are important differences as well. In general, today's leading companies are much more profitable.

profits from the recent bull market and lock in acceptable returns with more stable investments[3]. It is also important to note that our outlook and recommended investment positioning is totally stock market valuation dependent. If the stock market drops by 25%[4], we won't be running for the hills. Instead, we will likely look to be moving money back into equities[5].





What prompted us to take this action? The stock market has seemed overvalued to us for a while. This is nothing new. Furthermore, valuation alone is usually not a wise sell indicator. Overvalued markets can still be profitable as last year proved. Valuations can remain "above average" for long periods or even enter new decade-long regimes that pull the long-term average up.

Nevertheless, valuations have reached such a level that, if prior relationships hold true, forward returns will be lackluster. The chart atop the next page to the left, by J.P. Morgan, shows 10-year annualized returns experienced since 1998 arranged by their starting forward P/E (price-to-earnings) ratios. You can see the clear trend toward lower returns from higher starting valuations. Today's P/E of 22 points toward a minimal return from owning stocks over the coming decade. The second chart, to the right, presents similar data with a different valuation

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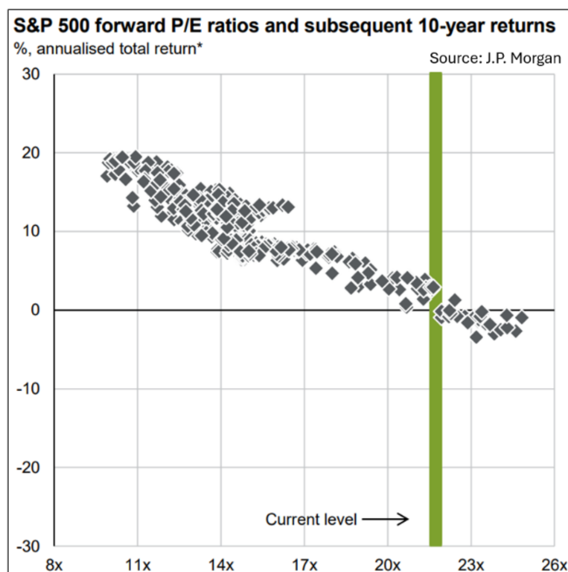
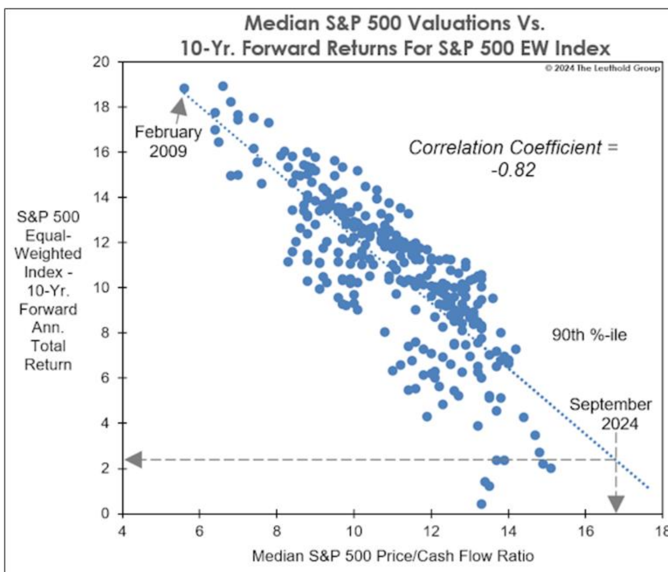
[3] In truth, we are only attempting to lock in returns. Our favored investments, like all investments, carry some level of risk. Even Treasury bonds are not truly risk-free.

[4] 25% declines are not all that infrequent: 15% of the past 45 years witnessed a 25% or greater intra-year decline in the S&P 500 Index.

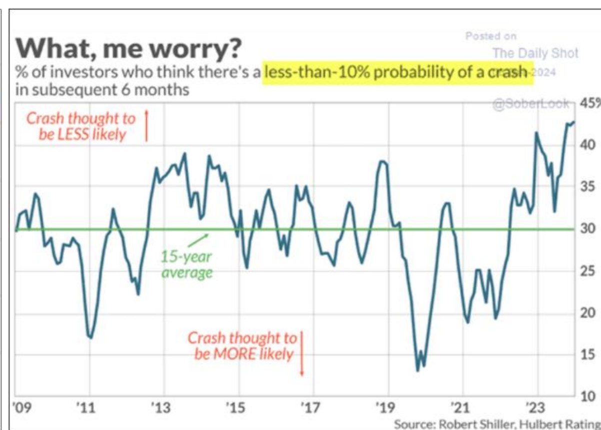
[5] It is important to note that because of the illiquidity of our private market funds, it wouldn't be possible to make this move on a dime. It takes some time get your money back when you make the decision to redeem. A little delay is probably fine when investing into a falling stock market and makes it a lot less scary.

measure. They both say the same thing: the last few times the market was this expensive, 10-year returns were quite low, or negative[6].





Valuation is one thing, but it was the combination of high valuation *and* ecstatic sentiment that got us to act. Never have so many people been so sure that the market is going to go up in the next 12 months. Is there anyone left to buy who already isn't in the market? An investing public this positive makes for a market prone to shocks of disappointment.



The positive sentiment is matched by hefty allocations of household wealth to stocks... allocations which can and perhaps will be reversed at some point in the future when something goes wrong. The chart below shows that this measure (stock allocation as a percentage of wealth) also implies lackluster forward equity returns (again, provided the future is like the past).

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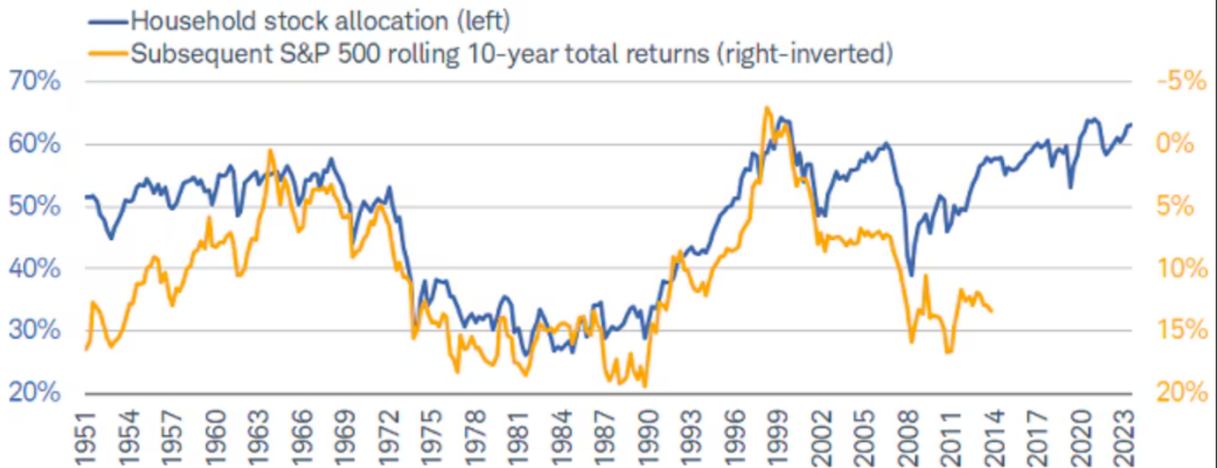
[6] The picture for five-year returns at current valuation is not that different: low or negative. However, there is basically no historical relationship between valuation and one-year returns, so anything can happen this year.



It's not enough to say you don't love the stock market. The real-world investor must determine where else to put their money. Financial history (including the recent bout of inflation) shows that cash seldom is a good long-term choice. "Alternatives" (as in not vanilla stocks and bonds) have been a big theme in our industry, but we never wanted to do them just for the sake of doing them. Now, however, we believe we've found a few options that are good enough to justify themselves. At the current time, our preferred destination for money coming from equities is in selected private lending funds.

We will first point out the drawbacks to these funds: they are illiquid and opaque, tax-inefficient[7], and investors have their money pooled together. Unlike with our publicly traded options, once you send your money in, you cannot immediately get it back.

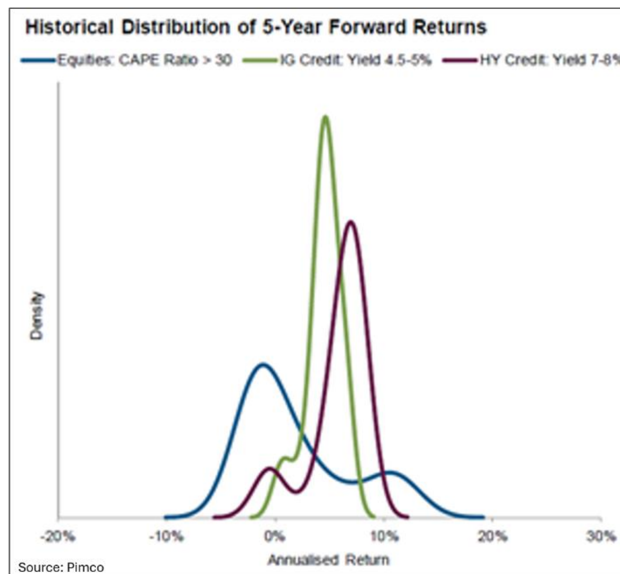
What outweighs these drawbacks are target returns in the high single digits, perhaps squeaking into double digit territory on occasion. This compares favorably with mid-single digit returns commonly available in publicly traded fixed income[8]. Our preferred funds make loans backed by good collateral such as real estate and other corporate assets. They are able to charge attractive rates because banks, which used to dominate this lending space, have backed away. Critically, our preferred vehicles don't lever up their funds to juice returns. Such tactics can go wrong quickly in the event of loan defaults. Our preference is for a reliable high single digit annual return instead of reaching for a more risky,

[7] For high tax bracket investors with taxable money to re-allocate, we have a different tax-advantaged fund we would recommend. This fund buys relatively stable assets that make tax-advantaged distributions. For clarity and brevity, this letter will only address the lending funds.

[8] Again, the situation is different for highly taxed accounts. Municipal bonds might be more appropriate in those accounts because a 4% tax-free yield (at negligible risk) is equivalent to 8% before tax.

higher yield. We also prefer the backing of collateral to enable recovery of value upon any loan defaults. We do not fully trust other so-called "private credit" funds which use leverage, are not always backed by hard assets and have become very popular of late[9]. While our funds are not bulletproof, we have a hard time imagining them experiencing large declines in value, something we have no problem at all imagining the stock market doing.

A recent PIMCO chart does a nice job of showing why one should be relatively happy locking up capital at a projected high single digit rate of return. Neither we nor PIMCO know what equities will return over the next five years. It could be a lot, but given stretched valuations, lower (and potentially negative) scenarios seem more likely. Fixed income options offer a much tighter distribution of possibilities. Investment grade corporate bonds look likely to deliver a mid-single digit annualized return, with potentially slightly better returns for lower quality high yield / junk bonds. We believe there is a good chance our preferred alternatives will do better still.



There is another reason to like our lending funds: the loans they make are short-term (often around one year) and thus more protected from increases in interest rates and inflation. If there was another bout of inflation, then interest rates would be expected to rise. Short-term loans, after they are repaid, can be quickly lent out again at new higher rates. Longer-term loans will suffer from inflation eating away at their principal without being offset by new higher coupons until they are repaid.

And we believe there is cause to be cautious on this front. The Federal Reserve has been cutting short-term interest rates, and yet, strangely, the 10-year Treasury yield has been *rising*. This is a trend which could become the headline story for 2025. It is ominous and unusual that long-term rates are rising as the Fed is cutting short-term rates. Are the "bond vigilantes" of the 1990s finally returning and sounding the alarm about ever worsening government finances? If so, we will be happy we have the protection of owning short-term, rather than long-term, fixed income assets.

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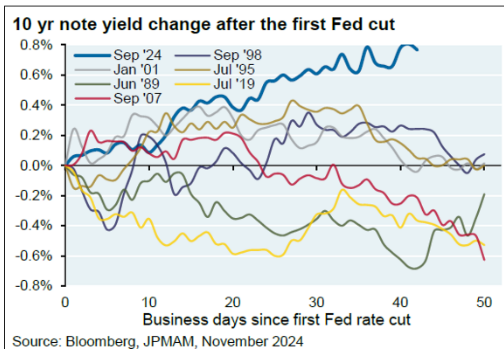
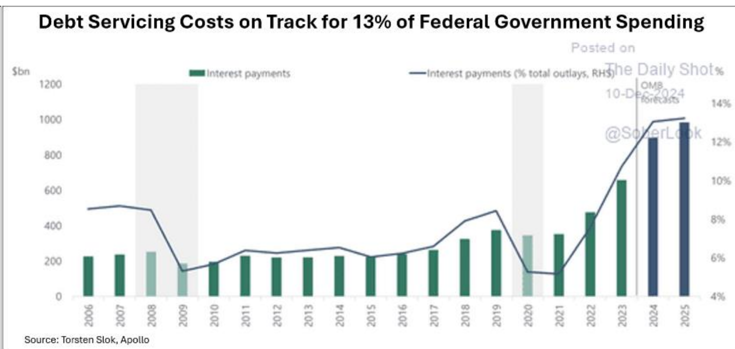
[9] Many of these private credit funds utilize high leverage to make loans to heavily indebted private equity companies. We don't like leverage on leverage and worry the wrong funds may someday face a redemption crisis, when investors cannot get their money back because too many investors are headed for the exits at the same time. Such panics can take on damaging self-fulfilling attributes.

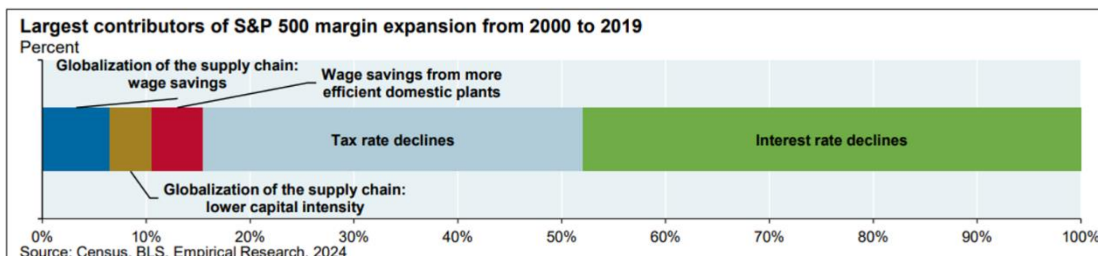




We are humble and experienced enough to know we may very well end up being wrong in expecting low stock returns. How might this happen? Valuations may not revert to their means and this time might indeed end up being different. While "this time is different" may set off alarm bells for some, it's important to keep in mind that sometimes it really is. Figures no less august than the Oracle of Omaha have been caught off guard by just such things. Revisit our opening quote: "In my opinion, you have to be wildly optimistic to believe that corporate profits as a percentage of GDP can, for any sustained period, hold much above 6%. One thing keeping the percentage down will be competition, which is alive and well."

Well, corporate margins have in fact run steadily above 6% of GDP for the last 15 or so years. That's a timeframe meaningful to most investors. Thus, things have indeed been different. Perhaps competition is dead and our tech-dominated economy will allow winner-take-all economics to persist.

Or perhaps Mr. Buffett will be proven correct, and corporate profits will not continue to remain so high. We have seen at least one analysis that indicates the recent expansion of corporate profit margins had mostly to do with low interest rates and low taxes. One of those factors has already changed[10] and it's easy to imagine the other one needing to change in the not-too-distant future.



10 To be fair, many public companies wisely took out long-term debt when interest rates were low, so it will be a while before the sting of higher interest rates is felt.

Our main point is that whichever situation prevails, whether profits march higher to justify today's lofty valuations, or whether the stock market stagnates or falls, we think we will be pretty happy knowing a good portion of our assets are intended to deliver steadier, and consistently positive returns.

As always, we do for ourselves what we recommend and do for you. We appreciate your trust and support and seek to earn it every day.

Sincerely,

John G. Prichard **Kurt Beimfohr** **Miles E. Yourman**

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