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Searching for "Enough": The Price of Risk in an Uncertain World

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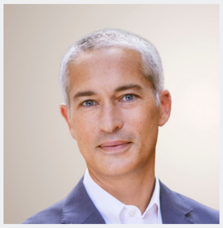

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In a recent edition of his newsletter, WSJ journalist Jason Zweig asks readers to ponder the following question: What risk-free rate of return, after fees and inflation, would induce you to exchange your financial assets for a guaranteed payout over fifty years (while satisfying your current spending needs)?[1] In other words, is there a real return level that provides enough? It is a crucial question that underpins rational investment decision making.

Today, investors can earn a real risk-free return of between 2.0% to 2.5%, in line with long-term averages and at the highest levels in the past fifteen years.[2] Maybe that isn't quite enough for you to put your investment portfolio on cruise control and start planning what to do with all of the time you were spending analyzing investments (or talking with your advisor); perhaps you hold out hope for aspirational wealth that will change your current lifestyle or open philanthropic opportunities for you and your family. There is nothing wrong with those desires. But how much risk are you taking to maintain the dream of a step function change in spending capacity? I'd argue you are taking a lot of risk today if you are investing in market-cap-weighted indices of large US stocks.

Risk is a broad term. It means more things can happen than will happen (and some of them are probably bad). To be useful, risk needs a modifier: price risk, valuation risk, leverage risk, macro risk, technology risk, etc. By some measures, risk in large US stocks is relatively low, as market capitalization is dominated by highly profitable businesses with fortress-like balance sheets and strong competitive positions. However, those positive characteristics are offset by very high valuation multiples and an unstable macroeconomic environment.

Investors use a variety of valuation multiples (or their inverses — yields) when they talk about whether stocks are cheap or expensive. The goal is always the same: to compare the market price to some proxy for the intrinsic value of a business. Nearly any ratio examined in today's environment will show an elevated (expensive) level compared to history. Some well-known metrics, with good empirical support as predictors of long-term returns, such as the Shiller CAPE ratio, are at levels that have been consistent with very low (near-zero) returns over the following decade.[3] Astute investors will point out that it isn't the valuation multiple alone that determines whether a company or asset class is cheap or expensive, but rather the multiple adjusted for quality and forward outlook. They are correct, but after a relentless rise in valuations since the Great Financial Crisis, bullish investors looking to justify fundamental value are left with some daunting math. Cash dividend yields (~1.2%) are near their lowest level in over a century, and while corporations are returning large amounts of cash to shareholders via buybacks, the returns on those repurchases decline as valuations increase. Earnings growth must be above average for decades to earn returns at the low end of historical standards, and that assumes that multiples don't compress from the current elevated levels.

[1] columnalerts.createsend1.com/t/d-e-skkihdl-l-r/
[2] https://fred.stlouisfed.org/series/DFII30
[3] https://shillerdata.com/. Cyclically Adjusted Price-to-Earnings Ratio (CAPE). Only the peak of the tech bubble witnessed a higher CAPE ratio. Excess CAPE yield relative to real interest rate is comparable to the tech bubble, the late 1960s, and the late 1920s.

Is it possible that corporate earnings will grow at a much faster rate over the coming decades, powered by a technological revolution brought on by AI investments? Sure, it is possible. However, I think there are a couple of good reasons to be skeptical. First, while large-cap stock indices today are dominated by extremely high-quality companies with durable competitive moats, they still compete in a capitalist system that, however slowly, erodes excess returns through competition. Large technology companies have had enormous success monetizing key products over the past couple of decades, but with new technologies come new opportunities for smaller competitors and risks to existing franchises. Second, the macroeconomic backdrop of the past few decades has been particularly favorable for large US companies, with declining interest rates, stable government balance sheets in the developed world, and inclusion of many developing countries into the global economy as consumers and supply chain partners. Some of these tailwinds are unlikely to blow as strong as they have in recent years.

So why might an investor deploy funds into expensive large US stocks instead of taking the market's offer of a 2.0% to 2.5% risk-free real return? I can think of at least a few reasons, some of them more rational than others.

- Concern about a decline in the value of the US dollar. Large US stocks provide exposure to real assets that grow with the global economy. Many of the largest companies have significant exposure to other currencies, providing a partial hedge against the dollar while still participating in global growth.
- International investors may be willing to pay up for exposure to US technology companies, which have been dominant on the global stage, taking leading shares in several key markets. International investors who invest only in home markets will be underexposed to one of the largest and fastest-growing sectors.
- Employees (and their advisors) may want to hedge a state of the world where AI eliminates many jobs and incremental benefits of productivity gains primarily accrue to the largest US technology companies.
- Growth in passive investing combined with a shifting composition within the remaining active investment community has left a less forceful cohort focused on the weight of long-term fundamentals relative to shorter-term trading outcomes. Retail and institutional investors focused on shorter-term outcomes care far less about the impact of valuations on returns.

Depending on your perspective, the first three bullet points above are either rational hedging or FOMO.[4] Regardless of your view, an investment in a market-cap-weighted index of large US stocks is a cheap and efficient means of gaining exposure, which may allow you to sleep a little better at night (for now). Beyond these rational hedging motivations, structural changes in the investment landscape may be amplifying valuation risks. I believe it is likely that a disproportionate share of the "smart money" that exited active investing over the past couple of decades were cost-conscious long-term investors who are more likely value investors. If true, the market may be prone to large deviations from fair value, and it may take much longer than expected for those dislocations to correct. These conclusions are the result of changes in the size and diversity of the pool of active investors, who work to uncover discrepancies between price and value, as well as shifts in the time horizons of active participants.

Of course, investors do not face binary investment decisions — risk-free or large-cap market index — but rather a spectrum of risk versus return trade-offs. I think investors who think they can hedge out the risk of a tech dystopia are fooling themselves, and there are lower-risk ways to gain exposure to global markets, which means investors have attractive alternatives to the large-cap indices if they are willing to deal with the implications of an evolving market structure. Many high-quality, cash-producing, large-cap companies trade at reasonable valuations, which allow for good returns via cash payouts (dividends and buybacks) and business growth. The Diamond Hill Large Cap portfolio owns a diversified collection of such companies and is constructed with an eye towards avoiding the valuation and concentration risks inherent in market-cap-weighted large-cap indices today. Given changes in market structure, it is critically important for long-term intrinsic value investors to have the capacity to suffer through extended periods of relative underperformance without compromising their philosophy. One of the most valuable assets a long-term oriented active manager can have in the current environment is a client base that understands their philosophy and the role it plays in achieving their objectives. We are fortunate at Diamond Hill to have wonderful clients who understand our philosophy well and have seen us execute it consistently over the decades.

[4] Fear of Missing Out

In a world obsessed with capturing every basis point of upside relative to benchmarks, we believe the real sophistication lies in knowing when the risk-free alternative offers genuine value — and when selective active management can deliver 'enough' without the embedded risks of today's indices. The current market for large-cap stocks is dominated by fear of missing out, driving up valuations of many of the largest companies to levels that leave a minimal margin of safety. I believe the Diamond Hill Large Cap strategy offers an excellent alternative for clients looking to achieve "enough" without taking undue risks.