Cornell Capital Group LLC

Investor Memo Q3 2022

The Times They Are A-Changin'

Efficient markets

If markets are efficient in that prices always reflect fair value and expected returns on stock are constant, why would anyone need an investment manager? There are two answers. The first, put forth by Sandy Grossman and Joe Stiglitz, is that a truly efficient market is a contradiction in terms. If investment research can never offer superior risk adjusted returns, because prices reflect fair value, then no one will do research. But if there is no investment in research, prices will diverge from fair value providing opportunities to earn superior returns on improperly valued securities.

The second answer is that even if the market is efficient, investor expected returns can vary. If this is the case, then fundamental valuation analysis can be used to predict long-run returns.

Putting the two pieces together, at the Cornell Capital Group we have concluded that estimating the fundamental value of equities using discounted cash flow analysis holds the key to improving long-run risk adjusted returns. There are no short-cuts or easy solutions.

Fixed income

Over the past several years beginning with the pandemic, the Cornell Capital Group avoided any significant investment in fixed income securities. We felt that extraordinarily loose monetary policy had depressed yields to levels that did not justify investment, particularly because that same loose monetary policy was likely to lead to inflation (we agreed with Larry Summers) and eventually higher interests that would produce capital losses on bonds. At the start of 2022, with the ten-year Treasury yield at 1.52%, fixed income was definitely a no go. Now the ten-year Treasury yield has risen to 3.69%. While we are still not enthusiastic about fixed income, we are at least on the fence. At the current yield ten-year Treasury bonds will offer a positive real return over the next ten years if the Fed is able to bring inflation down close to its target rate of 2%. Although there are still a lot of risks, including continued high inflation, for the first time in years fixed income is worthy of consideration.

However, in evaluating fixed income investments account must be taken of all three flavors of inflation: historical inflation, expected inflation, and unexpected inflation. In the quarter ahead we will be monitoring all three flavors as we assess how much capital to allocate to fixed income.

Is the stock market overvalued?

This remains a fundamental question. We initially addressed it in two videos streamed on May 3rd and May 4th 2021. On May 3rd, the S&P 500 was at 4,193. Our concern was that a market at that level implied that investors were willing to accept what by historical standards were exceptionally low risk premiums on stocks and if those

required premiums were to rise the market would fall. And fall it did. On September 30th, 2022, the S&P 500 closed at 3,585. Now the situation is more nuanced. The Shiller CAPE ratio has fallen from 36.94 at the beginning of the year to 26.84 presently. But it is still well above its long-run historical average and remains at level only exceeded in 1929 and the 2000 tech bubble. Furthermore, there are still companies with multi-billion dollar valuations that have yet to show positive EBITDA. On the other hand, we are starting to see some situations in which companies are selling at prices below what we see as their fundamental value. It is time to choose carefully.

Expected returns

Survey results reveal that investors are confused about the returns that can be expected on stocks. As of January 1, 2022, when the S&P 500 was at a record level of over 4,800, surveys indicated that the average investor was expecting returns of over 10% going forward. That expectation files in the face of the expected return that discounts analyst forecasts of future cash flows back to the current level of the index. As calculated by Aswath Damodaran, the implied future return on the S&P 500, given the level of the index on January 1, 2022, was near a record low of 5.75%. By September 23, 2022, the S&P 500 had fallen back to 3,693 and surveys suggested that most investors were expecting meager returns through year end. However, Damodaran's calculations revealed that the implied return had jumped dramatically to 9.75% - one of the biggest jumps he had ever recorded.

The answer to this apparent contradiction is that stock prices fell precisely because by September investors were requiring higher expected returns to hold stock

since (1) interest rates had risen – from 1.52% to 3.69% on ten-year Treasury bonds and (2) investors now saw stocks as riskier and consequently were requiring a larger equity risk premium. Put the two together and you get the record increase in expected returns that Damodaran documents. This inverse relation between the level of stock prices and expected returns is why, from the standpoint of maximizing expected returns, the time to buy stocks is when prices have been falling and investor are worried about the future not when prices have been rising and investors are optimistic. It is during troubled times that it is much easier to find companies trading for less than their fundamental value.

Looking ahead

Looking ahead we are focused on two issues. First, as noted above, fixed income is beginning to look attractive for the first time since the start of the pandemic. During the upcoming quarter, we will be actively evaluating investments in fixed income. Second, some of what we believed was the overvaluation of equities in the post-pandemic era of loose monetary policy has been washed away, in no small part due to a dramatic change in Fed policy. We are hopeful that careful fundamental valuation analysis will uncover attractive opportunities in the equity market in the upcoming quarter.

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