The Crescent Group

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Wealth Management
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Continued on page 2

2025: a balancing act

2024 capped a year of exuberance for financial markets. A Wall Street Journal article from December does a good job of summarizing last year's investment climate: "A new type of addict is showing up at Gamblers Anonymous meetings across the country: investors hooked on the market's riskiest trades." The current financial market exuberance brings to mind a couple of echoes from the past. The first is "irrational exuberance", which Federal Reserve Chair Alan Greenspan first used in December 1996 to describe the technology stock bubble at that time. The second is Warren Buffett's advice to "be fearful when others are greedy, and be greedy when others are fearful." Given the climate of exuberance we currently find ourselves in, we think it's important for investors to diversify well beyond those investments currently caught up in investor excitement.[1][2][3]

It's important to know that exuberance includes asset classes well beyond the traditional stocks and bonds that many think of as investments. In the mid 2000s, we saw exuberance for home prices. Mortgages were packaged into bonds and sold to investors as safe investments. After that, the housing market crashed in several markets, and mortgage bonds experienced widespread defaults. Today, we also see exuberance for investment markets beyond traditional stocks and bonds. Cryptocurrency is one such instrument. Speculators have pushed prices higher in the belief that prices will keep rising. These electronic coins are also viewed as scarce, although you can't make jewelry or electronics from them, as you can with scarce precious metals. It's impossible to evaluate their intrinsic worth.[4]

Private credit is another asset class that has exploded in popularity over the past several years. Private credit funds often use borrowed money to lend money to small, risky businesses. Unfortunately, they are often marketed to investors as safe alternatives to investment grade bonds. I worked at one of the world's largest private credit funds in 2008, and we saw some loans fall 50% or more in value during the recession. Most of the companies receiving private loans are small and highly indebted, without much of a financial safety net. There's a reason traditional banks don't lend to them.[5]

And finally, we've seen enthusiasm in real estate markets in recent years. For example, prior to the Covid-19 government stimulus, U.S. home prices increased 3.6% a year since 1900. It's somewhat staggering to see that home prices increased 51% in just a few years from 2019 to 2022.[6]

We've just reviewed how multiple different asset classes with widely varying characteristics are experiencing tremendous enthusiasm and exuberance right now. This tremendous enthusiasm reflects investor optimism about future prospects. As a result, there's a belief that prices will only rise in the future. Fifteen years ago, the pendulum was on the opposite side of the clock, and most investors only thought of limiting losses. Now that the pendulum has swung to the other side and risk taking abounds, it's important for investors to carefully manage risk.

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In the current climate of financial excitement and exuberance, it can be difficult for investors to distinguish between investing and gambling. Times like the present can blur the lines and confuse investors. During times of investor excitement, even investors who don't gamble are at risk of substantial loss if they aren't diversified well beyond the most popular investments. For example, if you look at the U.S. stock market, the largest ten companies currently make up 36% of the market. This is the most concentrated the U.S. stock market has been in more than 50 years. Historically, this level of concentration has had a bad ending. The last time the U.S. stock market experienced a similar level was during two prior bubbles – the Nifty Fifty bubble of the 1960s and the dot-com bubble of the late 1990s. Both of these periods were followed by crashes and "lost decades" where the U.S. stock market was flat for a decade or longer. For example, following the Nifty Fifty bubble, U.S. stocks were flat for 17 years from 1964 to 1981. And following the 1990s tech bubble, U.S. stocks were flat for 13 years from 2000 to 2013 (with a cataclysmic crash of 80% for the NASDAQ).[7][8][9]

As investors, we're faced with two important sets of facts right now. First, we know that trying to time markets doesn't work. By time markets, we mean trying to buy and own investments on the way up, and then sell when we think something bad is happening or will happen. The data show that investors who tried doing that reduced their returns by a staggering 60% over time. Yet we also see warning signs telling us we need to exercise caution in the current environment of excitement. Our strategy in this situation is to again look at data going back decades and see what has worked in the aftermath of past exuberant economies. One thing that worked is owning boring, dividend paying stocks. When the U.S. stock market was flat from 1972 to 1982, investors who reinvested dividends earned roughly 70% over that decade. In the more recent technology stock bubble of 25 years ago, we see a similar story. While the U.S. stock market fell for the decade from 1999 to 2009, boring industries with stocks paying dividends showed a gain. These include consumer and household products, health care, and industrials companies. When the current period of financial market enthusiasm fades, we once again expect these boring industries to deliver resilient results, just as they did in the aftermath of exuberance 50 years ago and 25 years ago.[10][11][12]

To sum up, we currently see signs of exuberance in many different asset classes. Decades' worth of data and investors with decades' long track records of success have cautioned about this exuberance. For this reason, we recommend investors exercise a heightened level of caution and care at the present time. Looking at what has worked following past periods of investor excitement gives us confidence that a diversified investment strategy can navigate the road ahead.

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Forbes Best-In-State Wealth Management Team 2024

Sources:

(1) The Wall Street Journal
(2) NPR
(3) The New York Times
(4) University of Chicago
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(11) Roger Thomas
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