How We Think About Wealth

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Financially, no two people are alike. Consequently, when it comes to wealth management, there's no one-size-fits-all approach.

Investment solutions should be personally tailored to fit your specific goals and needs. In this paper, we share our thoughts about wealth overall and how you might approach wealth-building and investment management depending on your stage of life and specific circumstances.

In business since 1992, CMG is a full-service investment office serving advisors and select high-net worth individuals and their families. We embrace a holistic, endowment-like approach that employs a Core and Explore portfolio construction process tailored to meet your objectives.

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Wealth through ingenuity.

In this paper, I share CMG's thoughts about wealth and how you might approach wealth-building and investment management depending on your stage of life and specific circumstances.

Before I plot individualized routes, let's first cover some general information. This paper is organized in the following sections:

- Setting the Stage
- Estimating Future Stock and Bond Market Returns
- What Valuations Tell Us About Future Returns
- The Merciless Mathematics of Loss
- Stock Market Cycles
- How We Think About Wealth: Core and Explore
- Conclusion

Setting the Stage

Today, the majority of wealth in the United States is concentrated among individuals who were born before 1964. Otherwise known as the Baby Boomers and earlier generations, these individuals hold 64.6% of the nation's wealth. The rest is held by Generation X (born between 1965 and 1980) and Millennials (born between 1981 and 1996) who hold 28.9% and 6.5% respectively.[1]

The financial needs of these investors are naturally very different. Generally speaking, Baby Boomers are in the retirement phase of their investment life cycle where they are focused on asset preservation and income while Generation X and Millennials are either in the accumulation or preparation phase, where they are focused on growth.

Regardless of your age and circumstances, we believe you should think about the money you have allocated toward savings as separate and distinct from the rest of your portfolio. As a ratio, this can be expressed as savings versus investments. Another way to think about it is liquid assets versus less liquid assets. This ratio will be different for everyone, but within the generational categories, Boomers tend to have more savings (liquid assets) and fewer long-term (less liquid) assets while the younger generations tend to have less savings and more long-term investments.

With more investment products available than ever before, and at considerably lower cost, investors of all ages and stages have a growing number of investment options that go beyond stocks and bonds. New opportunities include alternative investments, specialized funds, real estate, private equity and private credit. This paper presents a framework for how you might consider broadening your portfolio with the goal of achieving your investment objectives in today's challenging investment environment.

[1] https://www.federalreserve.gov/releases/z1/dataviz/dfa/distribute/table/index.html

Estimating Future Stock and Bond Market Returns

Having a clear sense of investment return opportunities greatly improves investment allocation decision-making. This is a key factor in making your investment decisions.

A 10-year Treasury yielding 4% will earn you a return of 4% *before inflation* over the coming 10 years. And for equities, current valuations can tell you a great deal about future returns. There are times in an investment cycle to play more offense (i.e. overweight traditional equity exposure) and times to play more defense (i.e. underweight/hedge equity exposure).

You'll see next that the return outlook for the S&P 500 Index over the coming 10-years is lower than the return one will earn investing in a 10-year Treasury. Factor in inflation and real return potential is an approximately 0%. This presents a meaningful challenge for all investors but particularly for those near or in retirement.

Traditional buy-and-hold-and-rebalance investment solutions may work well if you are younger. However, as you near retirement, the time needed to recover from a bear market loss can compromise your situation. In other words, where we sit in the long-term investment cycle is a vital piece of the puzzle for investors nearing or in retirement and is of less concern for younger investors.

Let's next look at where we sit in the long-term investment cycle.

What Valuations Tell Us about Future Returns

There is a simple way to put the above visual into numbers. Nobel Prize–winning economist Robert Shiller has studied price-to-earnings (P/E) ratios that date back more than 100 years and determined that when you buy something that's expensively priced (above the long-term growth trend), you get lower returns and when you purchase something that is inexpensively priced (below the long-term growth trend), you get higher returns. Logical, of course.

My friend Ed Easterling from Crestmont Research confirmed Shiller's findings: If a company's stock price is high relative to what it earns, the stock is expensively priced and future returns are likely to be low.

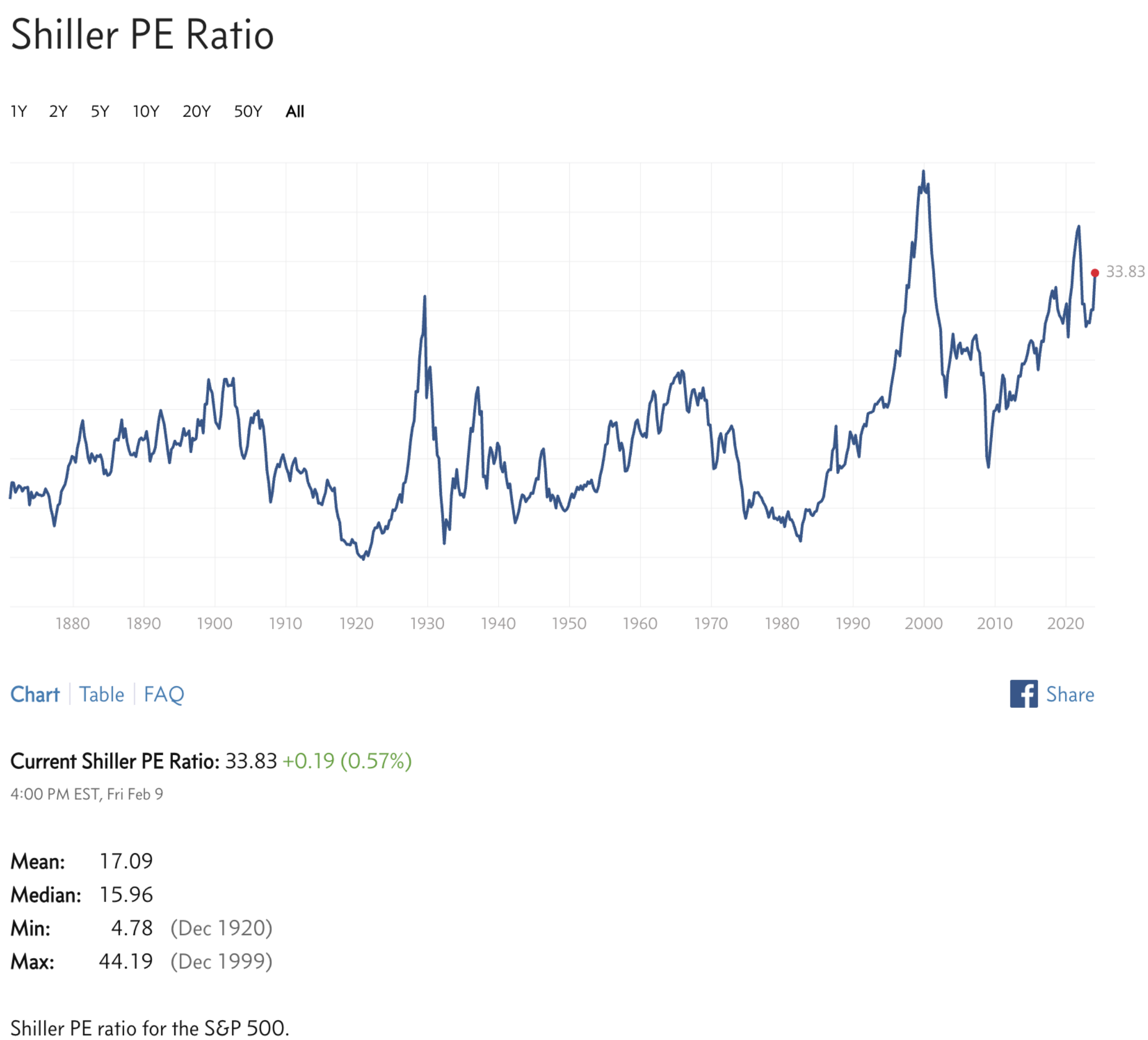
Let's look at the above chart again to visualize the logic. Think of the rising horizontal line as the point of good value. At any price above the line, you pay a premium, whereas prices below the line mean you're getting good value.

How can you know when that is?

Looking at the Shiller P/E overtime may help.

As shown in the chart below, the Shiller P/E on February 9, 2024, was 33.83. Note how this number compares to 1929, 1966, 1987, 2001 and 2021. The bottom line is the current number sits at the third highest reading dating back more than 150 years.

Chart 1



The chart on the next page puts the Shiller P/E ratios into a more practical context. It is useful in helping identify when probable future investment returns are best/least.

A Shiller P/E of 33.83 puts us in the top (most expensively priced) decile. Historical returns based on 113-year data suggest future returns will be between -1.8% and +3.6%.

Chart 2

S&P 500 INDEX TOTAL RETURN BY DECILE
10 Year Periods Ending 1909 - 2022 (114 periods)

We are here

We'd be better off here

DECILE	TOTAL RETURN BY DECILE RANGE FROM	TO	RETURN DECILE AVG	AVG BEGIN P/E	AVG END P/E
1	-1.8%	3.6%	1.3%	27.0	14.8
2	3.7%	5.4%	4.7%	16.3	9.5
3	5.4%	6.5%	6.0%	17.3	12.2
4	6.5%	7.6%	7.2%	20.6	19.6
5	7.6%	8.9%	8.2%	16.4	14.2
6	9.0%	10.9%	9.6%	17.4	18.3
7	11.0%	13.4%	12.0%	15.0	20.2
8	13.7%	14.7%	14.2%	12.6	20.9
9	14.7%	16.2%	15.5%	11.2	20.7
10	16.3%	19.2%	17.2%	11.4	23.4

Notes: Total Return Includes Dividend Yield; P/E is CAPE P/E10

The “We are here” red arrow points to our current state. The Shiller PE of 33.83 puts us in the most expensive decile or top 10% of all Shiller PE readings dating back more than 150 years.

In this decile, note that 3.6% compounded annual return was the highest instance of subsequent actual historical performance and, conversely, the -1.8% compounded annual loss for 10 years was the worst 10-year instance that occurred out of all the 10-year subsequent returns in Decile 1.

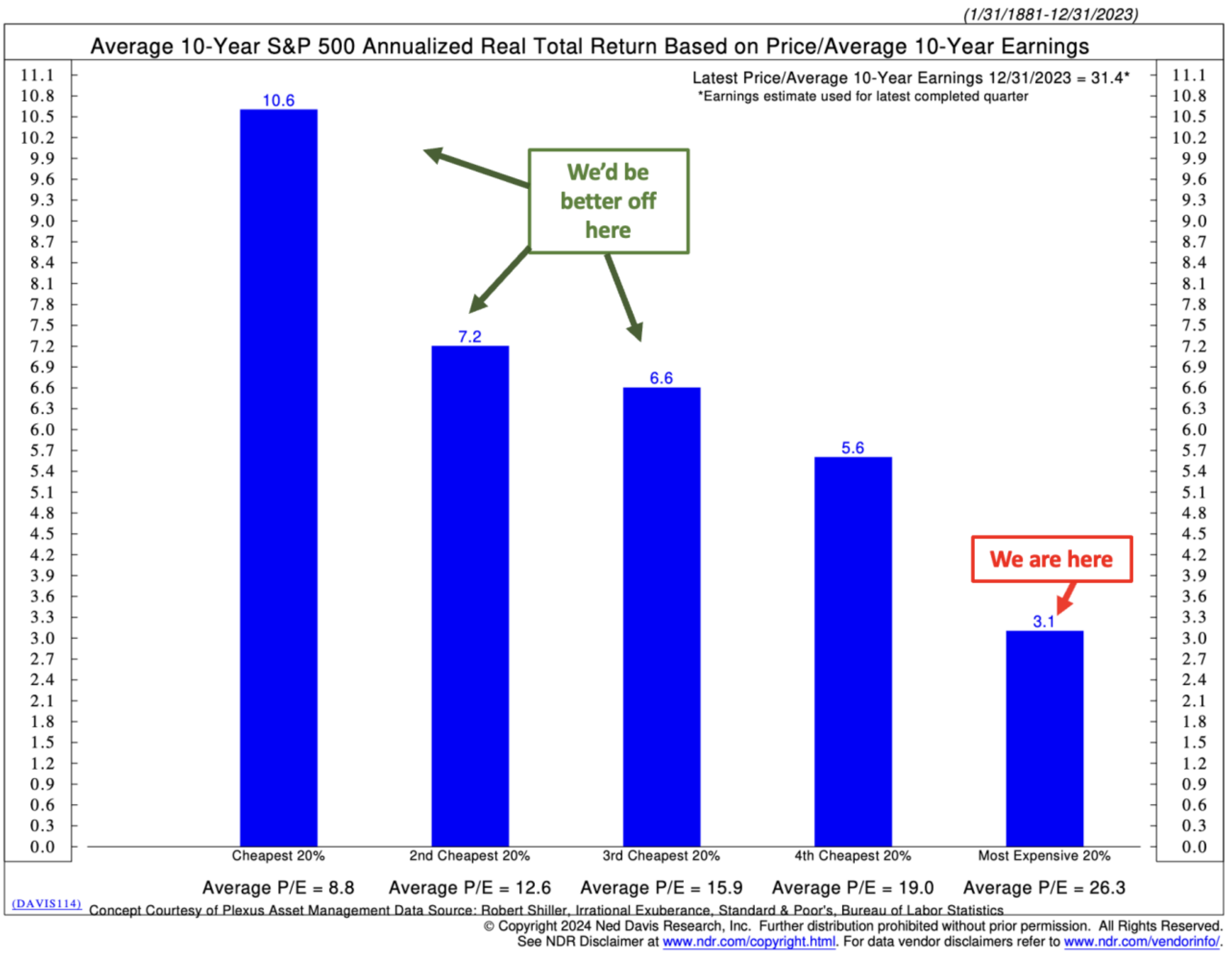
Vegas oddsmakers might estimate *the next 10 years may likely yield an average return of 1.3% per year before inflation.* That is not a return most investors are anticipating.

Look at the chart again and consider the S&P 500 index total return by decile, from 1909 to 2022 (114 periods). We should expect to be better off when the Shiller P/E drops to 17 or lower (see the in-chart commentary "We'd be better off Here"). An 8.8% to 10% per year return is closer to the long-term historical return most investors expect from equities. See how much higher your return potential becomes when you buy stocks at an attractive price relative to earnings (lower Shiller P/E)?

For this reason, we believe it is essential to factor market valuation into your investment process. Own more equity exposure when the return potential is high and adjust your exposure when the return potential is low. There are other ways to invest your wealth.

Chart 3

Ned Davis Research did a similar study with data from 1881 through 2022, in terms of 10-year S&P 500 annualized real total return (real means after inflation) based on price-to-average-10-year-earnings (P/E 10). A measure similar to the Shiller P/E. The P/E 10-Year earnings ratio was 31.4 on December 31, 2023. A better entry point is a P/E below 17.



Source: Ned Davis Research

Chart 4

Broadly speaking, the stock market is overvalued by most measurements as indicated in red in the following chart.

Factor	Start Date of Data	End Date of Data	Most Recent Value	Most Recent Tile
Median Price to Earnings	03/31/1964	12/31/2023	26.1	Extremely Overvalued
Price to GAAP Earnings	03/31/1926	12/31/2023	24.6	Extremely Overvalued
Price to Shiller Earnings	12/31/1925	12/31/2022	27.9	Extremely Overvalued
Price to Shiller Operating Earnings	01/31/1995	12/31/2023	28.6	Moderately Overvalued
Price to Shiller Operating Earnings (GAAP Earnings Prior to 1994)	02/29/1936	12/31/2023	28.6	Extremely Overvalued
Total Market Value to Shiller Total NIPA Earnings	02/28/1957	12/31/2023	28.0	Extremely Overvalued
Total Market Value to Total NIPA Earnings	03/31/1952	12/31/2023	26.0	Extremely Overvalued
Price to Cash-Adjusted Earnings	12/31/1973	12/31/2023	21.6	Extremely Overvalued
Price to Operating Earnings	12/31/1984	12/31/2023	22.3	Extremely Overvalued
Price to Forward Earnings	02/28/1983	12/31/2023	19.3	Extremely Overvalued
Price to 4Y Trailing & 1Y Forward Earnings	02/29/1988	08/31/2023	23.6	Extremely Overvalued
Price to 1Y Trailing & 1Y Forward Earnings	02/28/1987	08/31/2023	20.4	Extremely Overvalued
Price to Sales	01/31/1972	12/31/2023	2.6	Extremely Overvalued
Price to Book	12/31/1925	12/31/2023	4.1	Extremely Overvalued
Price to Cash Flow	01/31/1967	11/30/2023	17.8	Extremely Overvalued
Dividend Yield	12/31/1925	12/31/2023	1.5	Extremely Overvalued

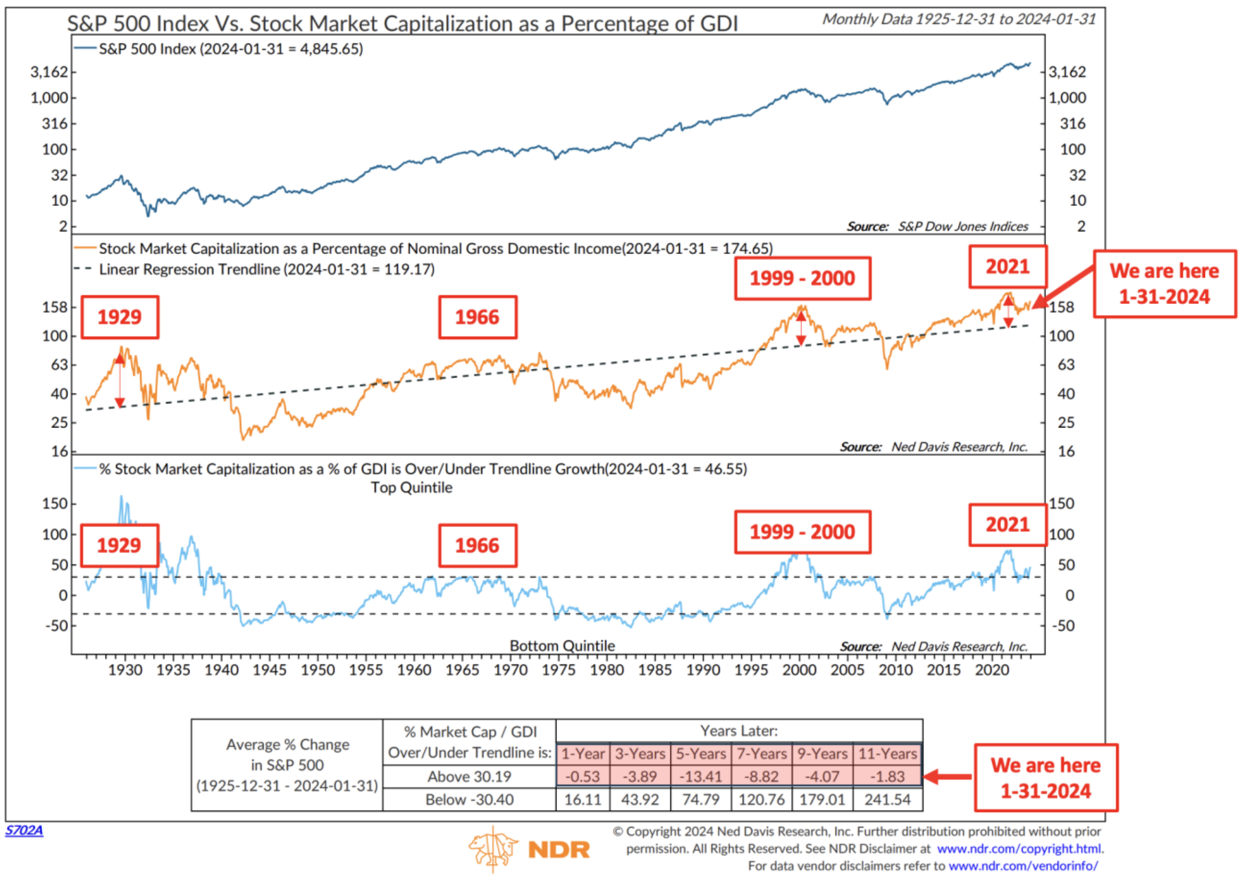
Source: Ned Davis Research

Chart 5

Finally, one of our favorite valuation measurements looks at the total value of the U.S. stock market (Stock Market Capitalization) as a percentage of U.S. gross domestic income. NDR plots the percentage calculation dating back to 1925 (orange line center section following chart). They then calculate how far above or below the orange line is from a long-term up-trending trend line. Finally, NDR sorted the measurements into quintiles and calculated the actual average percentage change in the S&P 500 Index 1-, 3-, 5-, 7-, 9-, and 11-years later.

As of 1-31-24, we are in the “Top Quintile” or highest 20% of overvalued readings. We highlight prior periods of excessively high valuations based on Stock Market Capitalization as a Percentage of GDI (gross domestic income).

Subsequent returns are shown in red in the lower section of the chart (We Are Here). You can compare the Top Quintile returns to the Bottom Quintile returns. While valuation levels tell us nothing about when a market may reach a peak, they tell us a great deal about the probability of future returns.



Average % Change in S&P 500 (1925-12-31 - 2024-01-31)	% Market Cap / GDI Over/Under Trendline is:	Years Later: 1-Year	3-Years	5-Years	7-Years	9-Years	11-Years
	Above 30.19	-0.53	-3.89	-13.41	-8.82	-4.07	-1.83
	Below -30.40	16.11	43.92	74.79	120.76	179.01	241.54

The Merciless Mathematics of Loss

"Compound interest is the eighth wonder of the world. He who understands it, earns it; he who doesn't, pays it." *-- Albert Einstein*

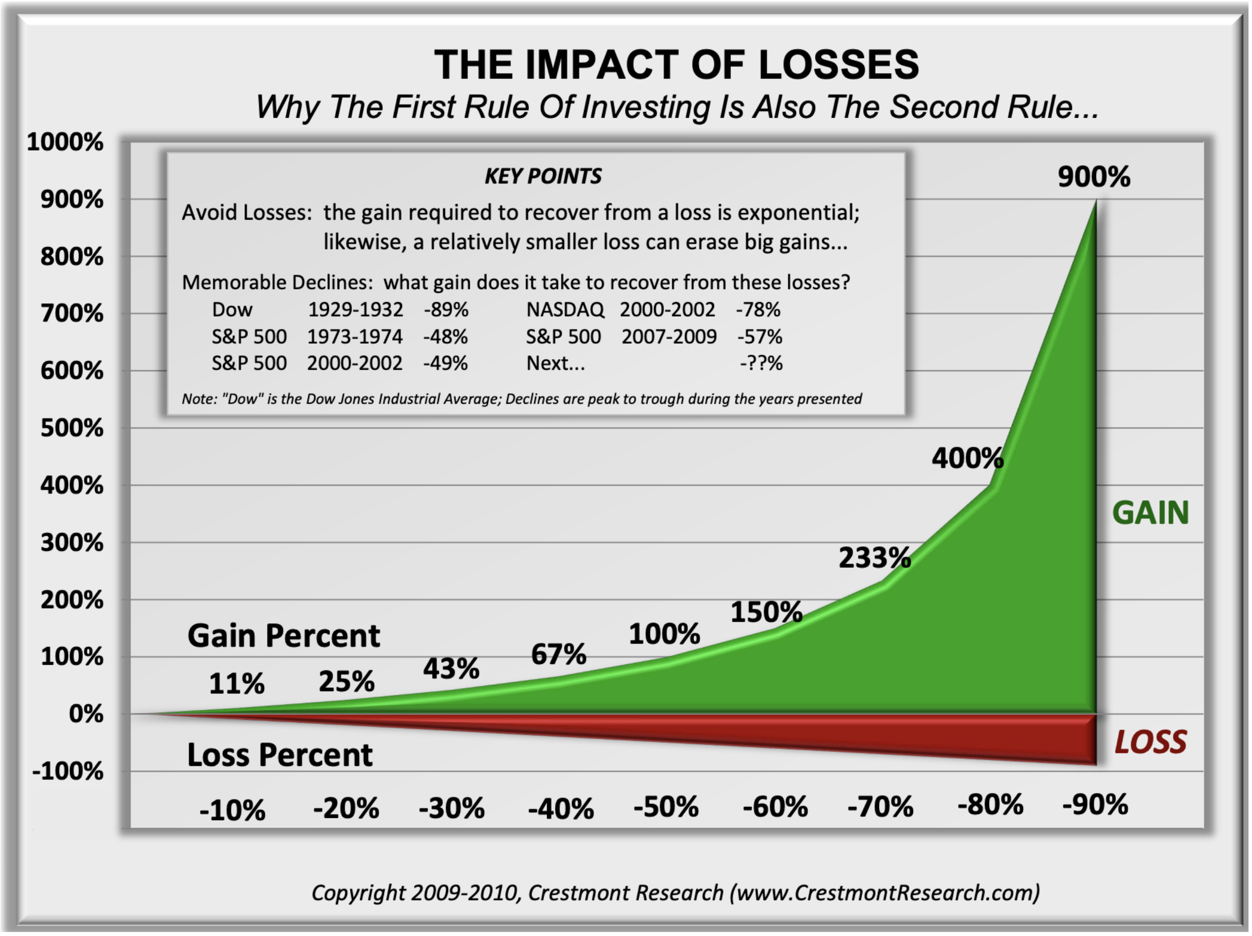
It's hard to make money and even harder to keep it. The main challenge is protecting your assets from inflation and taxation and to avoid inadvertently compounding the problem by making imprudent investment choices.

The real risk of investing is losing your capital permanently, without recourse ever to recover it. That's why it's crucial to understand the magic of compound interest and just how ruthless the math becomes when your investment portfolio declines 40% or more.

Recall that the equity market lost more than 50% of its value two times from 2000 to 2010. Subsequently, investors needed to generate a 100% return just to get back to even, which took as many 15 years, factoring in inflation. If recessions like that happen when you are 55 or older, it can devastate your retirement plans. ***Defending your capital against significant losses allows compound interest to work in your favor over time.*** That's just how the math works.

Chart 6

The following chart is helpful in showing the percentage return needed to overcome various declines in value.



Source: Crestmont Research

Stock Market Cycles

Understanding where the stock market is within a cycle is critical. Historically, U.S. equities have produced consistent returns over long periods of time. Since 1926, the S&P 500 Index has annualized 10.5%.[2] For discussion purposes, let's consider 10% per year the natural return rate for equities. It would be great if that 10% return was linear, like the straight line rising from left to right in the chart below.

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[2] Forbes: https://www.forbes.com/sites/forbesfinancecouncil/2022/06/16/investing-turns-out-it-is-not-a-short-term-phenomena/?sh=60d7a0a97fa4

However, returns go up and down based on corporate profits and investors' perceptions of future profits—it's investor behavior that causes equity market prices to rise above the natural return rate. Such excessive speculation eventually gives way to corrections. These fluctuations are far more extreme than changes in corporate profits and, like a pendulum, rarely spending a significant amount of time around the 10% average.

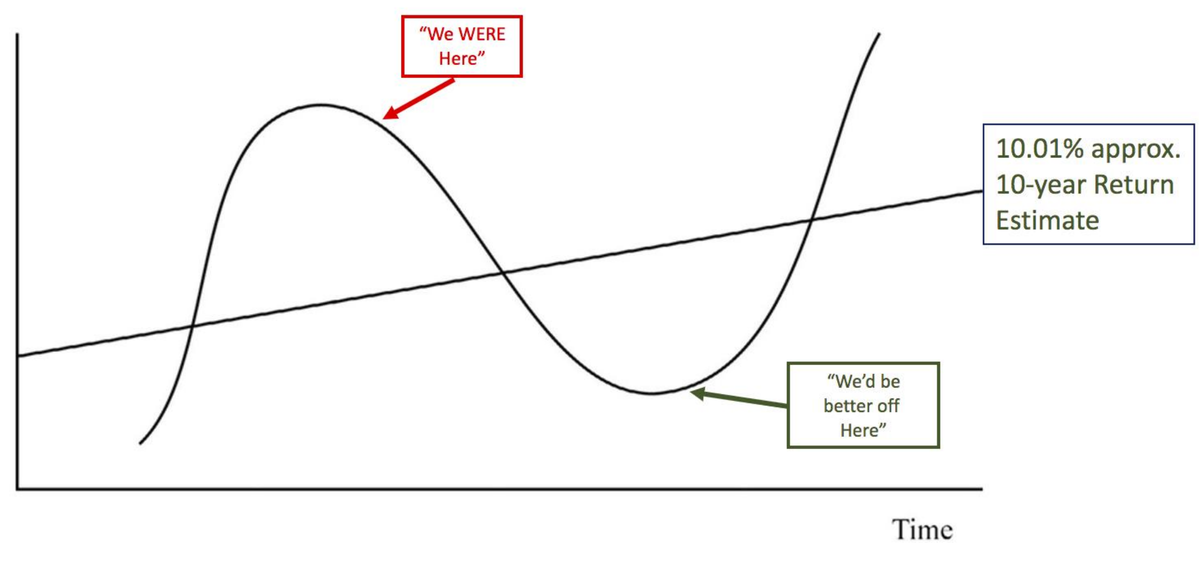
Furthermore, corrections don't generally drop back to the natural return rate. Thanks again to human behavior, they tend to descend below it. At the extremes, stock prices become over- or undervalued.

The best investment return opportunities come when prices correct below the natural rate of return, and the worst returns come when prices are above that long-term natural return line. Recognizing these tendencies and determining where we are relative to historical trends is key to your financial wellbeing, especially if you are nearing or in retirement.

The price you pay for an investment matter. There are times to overweight equities—in other words, to play more offense than defense—and times to underweight equity exposure (to play more defense than offense).

I frequently write about market valuations and investment cycles. The insights are well-reflected in this chart courtesy of Howard Marks, investment manager and author of *Mastering the Market Cycle: Getting the Odds on Your Side* (in-chart commentary is mine).

Chart 7



Howard Marks, Mastering the Market Cycle

The difference in the 10.5% reflected in the Forbes article and the 10.1% reflected in the above chart from Howard Marks book has to do with the time frame measured. To set general expectations, let's call the long-term return potential from the S&P 500 Index 10%.

Markets do indeed cycle and while there is a high probability of positive inflation-adjusted stock market returns when any 10-year time long-term time horizon it is important to note that in 27 of the 85 decade-long periods surveyed from 1925 through 2021[3], the inflation-adjusted rate of return was less than 5%, and 10 of those decade-long periods possessed negative average annual returns. 10 of 85 decade-long periods produced negative returns. Markets do indeed cycle and valuation levels can help us gage the potential for return and by extension the degree of potential risk.

Understanding Secular Stock Market Cycles

According to Crestmont Research (and we agree) there are three primary drivers of stock market returns: 1) earnings growth, 2) dividend yield and 3) the change in P/E ratios over time.

How do these components relate to each other?

1. Earnings growth is closely correlated with and caused by economic growth.
2. Earnings growth and P/E change determine capital gains and losses.
3. Dividend yield is significantly driven by the level of valuation (i.e. P/E Ratio) at the time of investment.
4. Dividend yield provides return in addition to any capital gains or losses.
5. The level and trend of P/E is driven by the inflation rate: low, stable inflation drives P/E higher; high inflation or deflation drives P/E lower.

Looking at valuations to determine when the odds are stacked in your favor and when they are not can help you shape your portfolio structure. But there is another benefit: Understanding current valuations will help you develop the courage to take advantage of the opportunities that emerge and maintain the discipline to avoid high-risk periods in the market cycle. Warren Buffett once said, "It's wise to be fearful when others are greedy and to be greedy when others are fearful." As his partner Charlie Munger masterfully put it, "Extreme patience combined with extreme decisiveness. You may call that our investment process. Yes, it's that simple."

If you're a 60/40 (60% stocks, 40% bonds) investor, understanding where we sit in an investment cycle is critical. With valuations high and bond yields low, we believe the next 10 years will produce flat to negative real returns for this portfolio allocation approach.

Currently (January 31, 2024), due to high current valuations, the coming 10-year return probability for the S&P 500 Index, before inflation, as reflected in Chart 2 above, is likely to be between -1.8% to +3.6% annualized, or a negative 1-, 3-, 5-, 7-, 9-, and 11-year return outcome

[3] https://www.forbes.com/sites/forbesfinancecouncil/2022/06/16/investing-turns-out-it-is-not-a-short-term-phenomena/?sh=60d7a0a97fa4

as reflected in Chart 5—far from what Wall Street and most investors are anticipating. And ***with bond yields running well below the rate of inflation, a traditional stock and bond portfolio isn't likely to meet expectations.***

If you are in or near retirement, there is reason for optimism. We encourage you to consider an adaptive "endowment-style" investment approach that brings in a much broader set of investment opportunities than simply buying-and-holding stocks and bonds. The goal of this approach is to generate a sufficient retirement income combined with a focus on preserving your core wealth. While, at the same time, not losing focus on allocating a smaller percentage of your overall wealth focused on growth.

Fortunately, there are a number of alternative investments available to all investors, and an additional set of investment tools available to investors meeting a higher net worth threshold, that may provide added value to portfolios.

Beyond gaining access to select investments, the ability to research these opportunities and perform due diligence is paramount. The sizing and diversification of investments must also be thoughtful and appropriate, as not every investment will perform as expected.

We cover some of the concepts and considerations throughout this paper, but before I share our rationale for how you might construct your portfolio, we introduce our broader thinking about wealth.

How We Think About Wealth: Core and Explore

We encourage you to view your investments as a collection of assets, with each asset serving a different function. Many investors are invested in traditional stock and bond portfolios. We favor going beyond cookie-cutter stock and bond models to include alternative investments, real estate, private equity and private credit.

Find diverse investment components with return and risk profiles separate and distinct from the traditional stock and bond markets. And distinct and diverse from each other. Combining them together creates a portfolio better equipped to withstand inevitable market turbulence that occurs over time.

Doing this requires the right information, access, due diligence, and ongoing research support.

80% CORE / 20% EXPORE

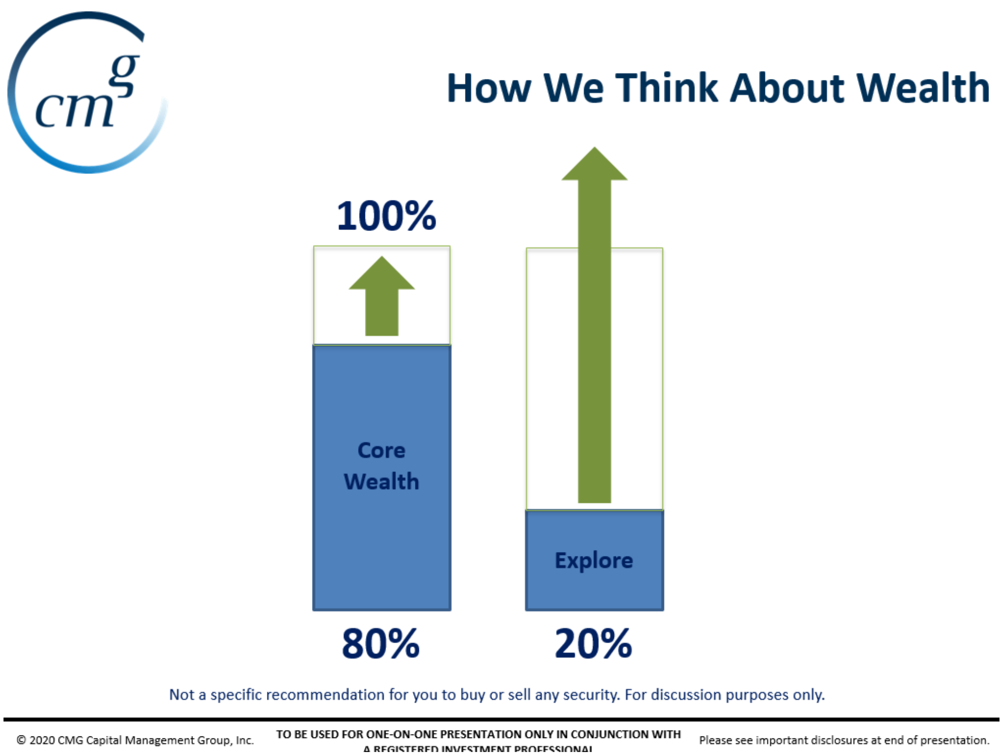
Core is the wealth preservation portion of your portfolio—the lower-risk portion of your portfolio that, if desired, can produce income for you.

As a rule, we advise building a strong CORE portfolio for 80% of your investable capital. The goal is to deliver a risk/return/income experience that's appropriate for your individual situation. The objective is to provide you with a relatively predictable outcome over a predetermined time frame—growing 80% of your wealth (CORE) by about 7% per year gets your 80% back to 100% in 4-years. Preserve, and conservatively grow, your core wealth.

For your CORE investment allocation, consider well-collateralized, floating-rate, specialty lending funds yielding in the high single-digits to mid-teens with stable net asset values (NAVs) and/or select funds that are focused on generating absolute return. We favor funds that distribute cash flow to you. We share a few ideas further below.

With the core portion of your wealth defended, consider investing the remaining 20% of your wealth in ultra-aggressive, risk-on investment opportunities. We call this the EXPLORE portion of your portfolio. Here we seek to invest companies with three common characteristics: 1) Edge in technology, 2) good management, and 3) the potential to disrupt an exceptionally large market. Think gene editing, bio pharma, deep tech/AI. We look for a minimum 10x potential return for each EXPLORE opportunity. As reflected in the next chart, the objective is for the CORE portion of your wealth to enable you to EXPLORE.

Chart 8



The right investment platform can provide you with an array of investment solutions. Of course, there is no way anyone can guarantee returns and some investments may lose some or all the money invested. Because investments held in the EXPLORE portion of your portfolio are high-risk, we recommend being highly selective and sizing your allocations in a way that no one investment bet can blow up your wealth. If you allocate 2% to an EXPLORE opportunity and it goes to zero, your portfolio is only down 2%. The CORE enables the EXPLORE.

Core Investment Examples

Below are descriptions of several investments we allocated to in 2022/23:

A trade financing strategy run by a former co-chief investment officer of Harvard Management Company and developed while working at Harvard. Harvard seeded the managers when they left to form their own firm in 2018. Anticipated net returns are in the mid-teens. Of course, no guarantees can be made.

- A niche trade financing strategy that provides investors with a differentiated opportunity in ultra-short-term risk exposure and pays out quarterly cash distributions, provides a stable net asset value and has low correlation to the broader capital markets.
- The fund writes a form of Chapter 11 bankruptcy protection insurance for small and mid-sized manufacturers. The targeted annual returns in the mid-teens and has a one-year lock-up period with quarterly liquidity.
- Currently available to qualified investors.
- Performance history is available for qualified investors.

A hard lending private credit fund backed by pharmaceutical royalties. This is a specialty, short-term lending fund that lends money with collateral backed by pharmaceutical royalties. The founder was a member of the Investment Advisory Committee of the State of Virginia Retirement Plan and served as its chairman from 1990 through 1994. He also served on the Board of Trustees of the Virginia Retirement System. The firm is a leading investor in the pharmaceutical royalty space.

- The fund targets current income and long-term capital appreciation by building a diversified portfolio of investments tied to royalty rights on approved in-market pharmaceutical products.
- The current yield distribution about 7% with a targeted annual net return of 8-10%. The fund has a two-year lock-up period and quarterly liquidity.
- Currently available to qualified investors.
- Performance history is available for qualified investors.

A multi-strategy, multi-manager absolute return strategy hedge fund. The fund allocates capital to teams of traders with different absolute return-focused investment disciplines.

- The fund can trade markets long and short with a history of favorable performance in both up and down markets.
- The fund has a one-year lock-up period with quarterly liquidity.
- Currently closed to new investors with potential future capacity.
- Performance history is available for qualified investors.

No guarantees can be made for any of the above strategies. All investing involves risk of loss. Selection and due diligence can help reduce risk. Diversification is critically important so that no single investment can derail your portfolio.

Explore Investment Example

These explore opportunities, as we call them, could be in growth stocks, emerging markets, unique opportunities in undervalued stocks, real estate, venture capital, health-care, biotech, commodities, agriculture, disruptive technology, or artificial intelligence (AI). You may also consider early-stage venture capital, late-stage private equity or publicly traded equities. These areas may offer exceptional return potential over the next 10 years—potentially 10x, regardless of where we sit in the market cycle.

Below is a description of an investment we used as an Explore allocation in 2022:

A biotech agriculture company that has patented non-GMO gene-editing technology that produces crop seeds with traits that are nature-identical. Traits include resistance to disease (reducing farmers' fungicide use), weeds (reducing herbicide use), insects (reducing pesticide use) and protection against climate change (i.e. heat, drought).

- The company was founded in 2001 in response to European regulatory restrictions on GMO crops.
- The company licenses traits to seed companies through a royalty-based business model.
- This is a patent-protected technology going after a massive opportunity that we believe may disrupt the agriculture chemical industry as we know it.
- This is an example of a late-stage private equity opportunity.
- Currently closed to new investors with potential future capacity.

The idea is that if you allocate 2% of a portfolio to a high-risk investment such as this and the investment fails, your portfolio will only be impacted by 2% that year. If we are right, a 2% allocation may meaningfully advance your family's wealth. Consider a 1% allocation up to a 5% allocation depending on the potential opportunity.

Conclusion

The way we think about wealth is to focus on defending and carefully growing your CORE allocation while providing potentially high-performing EXPLORE opportunities. The objective is to increase the 80% back to 100% in 4-5 years (7% annualized return grows 80% back to 100% in about 4 years).

The 80-20 Core and Explore percent breakdown is a hypothetical starting point. Depending on your individual timeline, needs, risk tolerance and goals, you can change the percentages to dial the risk up to, for instance, a 60-40 or 50-50 split, or dial it down to 90-10 or 100-0.

Your selected investments and your level of risk should be tailored to meet your specific needs and objectives. Sizing risks correctly is important because proper sizing allows you to take a deep breath, maintain focus on the long-term picture and importantly remove emotion from your wealth management process.

The modern day requires a modern approach to investing. In business since 1992, CMG is a full-service investment office serving advisors and select high–net worth individuals and their families. We embrace a holistic, endowment-like approach that employs a Core and Explore portfolio construction process tailored to meet your objectives.

As a multi-family investment office, we have built a network of trusted relationships through which we are able to source and gain access to unique, niche and differentiated investment opportunities. Working with us, you, and your family gain access to our network.

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