January 2025

Increased Market Risk Warrants Defensive Tilt

Today, the S&P 500 Index and the MSCI World Index are increasingly concentrated on a small group of U.S.-based technology related stocks. Looking back at market history, we believe that risk has increased in portfolios benchmarked to these indices, since expectations on these stocks are high and so too are their valuation multiples, setting up for disappointing future returns.

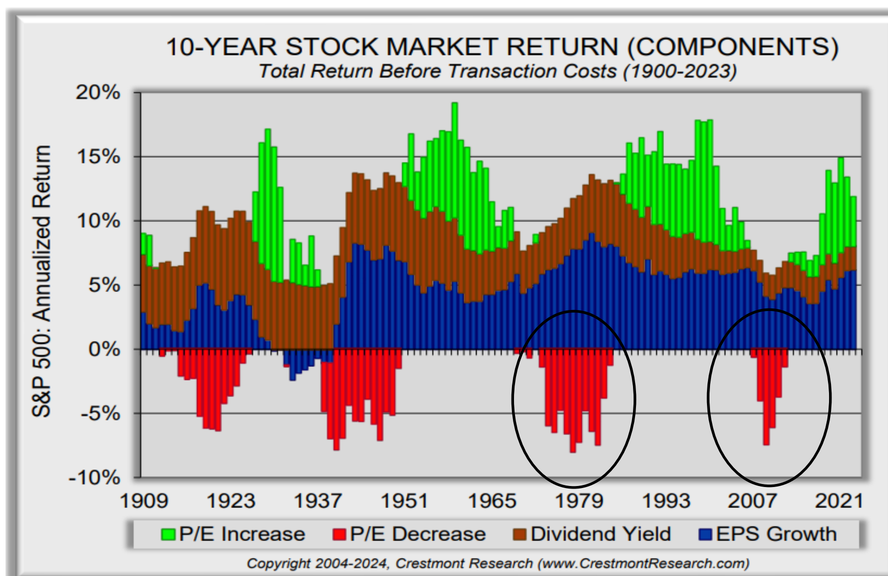
Where do stock returns come from?

The pioneer of the index fund, Jack Bogle, had a simple formula to predict stock returns:

Future Total Return = Dividend Yield + Earnings Growth in % + Changes in the PE multiple in %

- A dividend is a recurring quarterly (usually) payment
- Earnings growth is the increase in a company's earnings per share
- P/E multiples can expand, increasing one's total return, or they can contract and detract from one's total return. P/E multiples are impacted by investor's expectations of growth, stability and riskiness, to name a few factors.

Each bar in the following graph illustrates the 10-year market returns for the S&P 500 broken out by these three components going back to the beginning of the 1900s. Quite reliably, every series of P/E increases (depicted by green bars) is followed by a series of declining P/Es (depicted by red bars). Each time the 10-year stock market return peaks, the largest component of the return in that year is the P/E increase, which gradually grinds down in the successive periods before turning negative.



Source: Crestmont Research.

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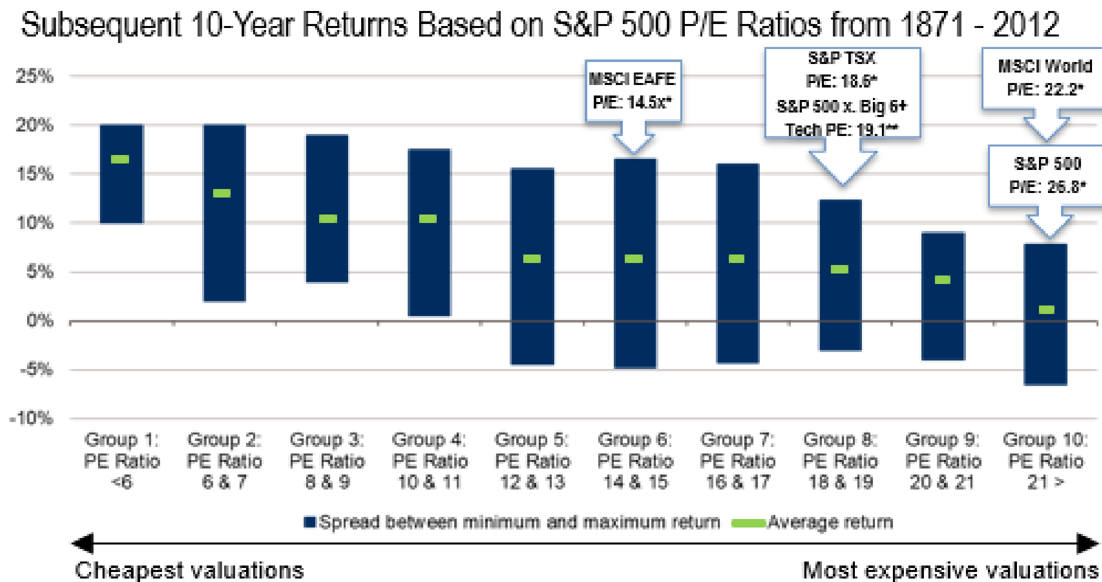
We see similarities with the Nifty Fifty of the 60s/70s and the Dot Com era of the late 90s to today's concentration of the Big 6 Tech+.[1] In both periods, market participants bought into the market darlings of the time becoming increasingly insensitive to the price they were paying. Investors' preference for these stocks increased their concentration in the index and the market's P/E multiple too.

What occurred in both eras was that valuations became stretched and eventually took the wind out of the sails of the whole market as the leaders came down. This led to P/E decreases for years afterward that lowered total returns (circled in the previous graph).

How do the P/E multiples of major markets compare at year end 2024?



Graph Source: Plexus Asset Management (based on data from Prof Robert Shiller and I-Net Bridge). As at Sept. 30, 2012.
**Source: FactSet, LTM as at December 31, 2024*
***Source: UBS.*

The chart above shows the historical average return (green dash) that market participants can expect going forward based on the starting P/E multiple they invested in. The chart also shows the dispersion of returns for each group showing the highest and lowest historical returns, based on the starting P/E multiple.

Today, the most expensive markets are the ones that are weighted to the Big 6 Tech+ companies. The S&P 500 and MSCI World both have a 10-year average expected return of a mere 1%.

In the long run, valuation explains about 80% of returns. Canada, the International market, as represented by the MSCI EAFE Index, and the S&P 500 excluding the Big 6 Tech+ companies, all have lower P/Es and offer future expected returns in the 5%- 6% range annualized over the next decade, based on today's P/E multiples. In addition, the Canadian and International markets have cheaper book values and higher dividend yields and we can therefore expect them to be reasonably more defensive in market declines.

Market declines happen and market timing is difficult to do consistently well. A better solution is to tilt your portfolio more defensively.

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[1] *Nvidia, Amazon, Tesla, Meta, Alphabet, Microsoft and Apple*

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Action: Diversify outside the U.S. Big 6 Tech+

In conclusion, we believe there is increased risk in investor portfolios given the concentration of the Big 6 Tech+ companies within current U.S. and world market index exposures. Should earnings expectations of these stock-market dominant companies be revised downwards, their actual earnings disappoint or the broader economy falters, there is a high likelihood that the multiple component of future return for these stocks could contract – and perhaps severely. We believe it is prudent for investors to stay invested but tilt their portfolios to areas of the market with better risk and reward tradeoffs: well selected, value-focused equities within the Canadian and International markets.

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