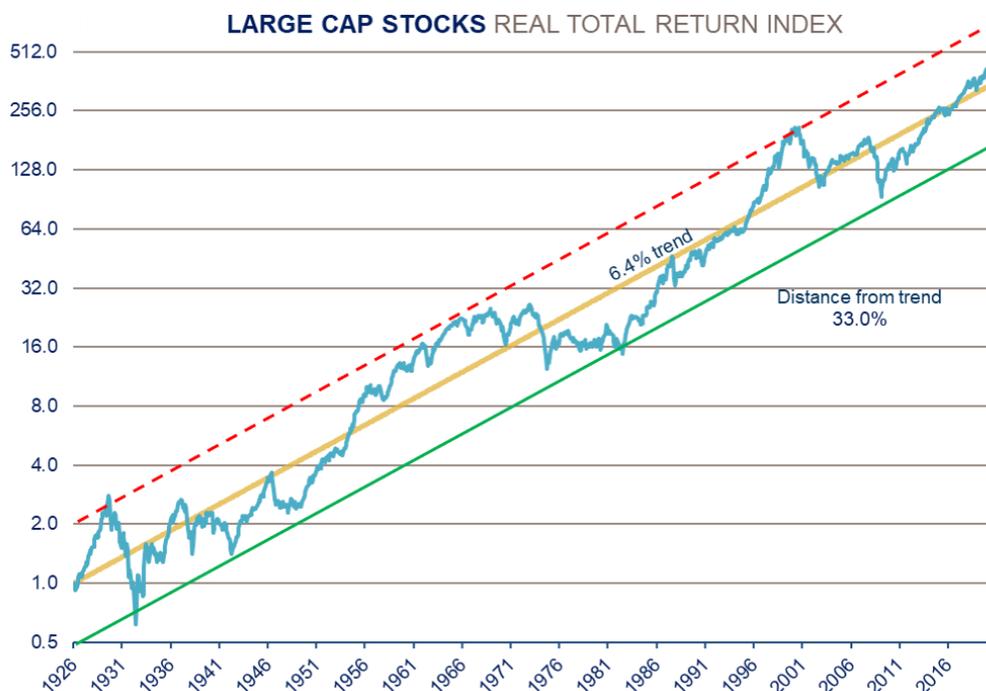


Are Large Cap Stocks Expensive? Lessons from Price Matters®

FROM CURRENT LEVELS, FORECASTING A LOWER THAN AVERAGE 10-YEAR RATE OF RETURN IS PRUDENT, BUT HISTORY SHOWS A WIDE RANGE OF OUTCOMES.

A forecasting tool for long-term returns: Our Price Matters® framework is a way of looking at the long-term history of stocks to get a guide as to the 10-year outlook for future returns. We do not believe it is a timing tool. The premise is this: Since 1926, US Large-Cap stocks, defined as the largest 20% of the CRSP total stock universe, has had a consistent trendline of 6.4% when we look at total returns (price plus reinvested dividends) net of inflation (Consumer Price Index, CPI). This history is shown in the first chart below. In our opinion, the consistency of this rate of return over such a long period makes it a valuable tool in putting current levels in a historical context.

LARGE CAP STOCKS WERE 33% ABOVE TREND AS OF 8.31.20



Source: RiverFront Investment Group, calculated based on data from CRSP 1925 US Indices Database ©2020 Center for Research in Security Prices (CRSP®), Booth School of Business, The University of Chicago. Data from Jan 1926 through Aug 2020. Past performance is no guarantee of future results. It is not possible to invest directly in an index.

Opportunities at extremes: Given the history of reverting to this trend, investors should consider lowering their return forecasts as stocks rise above the trend and increasing their return forecasts as stocks fall below the trend. However, in our experience, this framework is most valuable at extremes. We seek to illustrate this in the chart above. The red dotted line parallels the trend but is drawn through previous peaks in 1929, 1966



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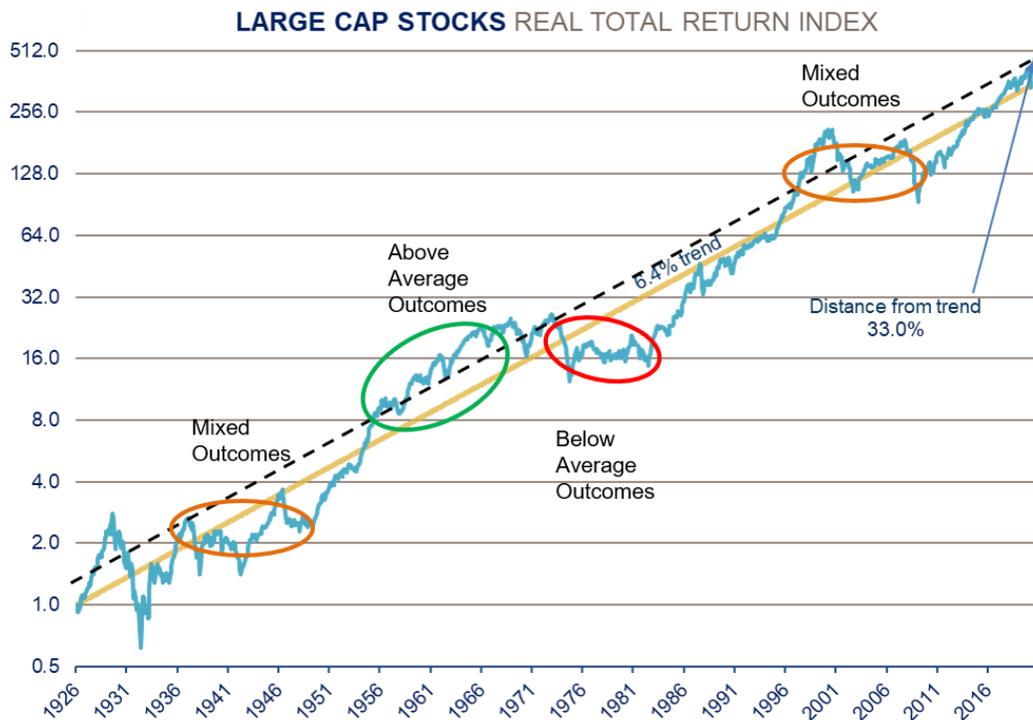
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- We believe the Price Matters® framework is a valuation gauge, not a timing tool.
- US Large-Cap stocks are roughly 30% above trend, but not at extremes.
- History shows a wide range of outcomes when starting 30% above trend.
- Thus, our current outlook for earnings and interest rates is important.

and 1999, all of which preceded meaningful bear markets over the subsequent 10 years. Likewise, the lower solid green line is drawn through the extreme lows of 1932, 1982, and 2009, all of which presented better than average return opportunities as stocks recovered to the long-term trendline. As you can see, these extremes are rare.

What we have learned from our Price Matters® work is that the range of outcomes from less extreme starting points has varied considerably and has been much more dependent on the economic regime. Large-Cap stocks were 33% above trend as of August 31st which, as the chart shows, is not an extreme. We see four previous times in history where stocks began at a similar distance above the long-term trend to the August 2020 level. The 10-year real total returns following these timeframes were very different.

HISTORY SUGGESTS THE ECONOMIC REGIME MATTERS



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Lessons from four regimes with similar starting points to current levels: The dotted line in the chart above is a parallel line drawn from the August 31, 2020 starting point – 33% above trend. The ovals were all previous times when the distance from trend at the starting date was similar to the August 31st level. While Large Cap stocks were consistently a similar distance at the start, the difference is the economic backdrop during these time periods.

The periods beginning in the late 1930s and late 1990s shown in the 1st and 4th ovals were tumultuous times. The fact that the net effect was relatively flat in both cases seems much less important to us than the 3 and 5-year periods in between. The first period was dominated by WWII. Stocks suffered significant losses in the lead up to the war only to regain all of the losses once investors began to anticipate the allied victory and the immediate aftermath of the war. Given that the first period was dominated by WWII, we do not see it as a useful guide to today's situation. Similarly, the fourth period involved 3 distinct phases: the tech stock bubble, the post 9/11 recession, and the Real Estate bubble, which ended around 2007. We believe the confluence of these three events were greater drivers of performance than the initial distance above trend.

The two periods which we think may be more helpful to today's analysis are represented by the 2nd and 3rd ovals. The second oval, which began in the mid-1950s, shows that Large-Cap stocks started above trend and remained so throughout the entire period. In the post-WWII world, with Europe and Asia reeling from the effects of the war, US companies gained global brands in technology, industrial companies, pharmaceuticals, and especially consumer companies from soft drinks to fast food to household products. It was also a time of low inflation. One might call it the first 'golden age' of American globalization. There are parallels to today, another time of US dominance, especially in the world of technology and the consumer businesses which utilize that technology. While overall global economic growth has been sluggish, growth in US Large-Cap earnings, especially the earnings of large technology companies have been strong.

The third oval, which began in the early 1970s, was the opposite of the second. This was a period dominated by sharply rising inflation and interest rates which led to very poor returns from US Large-Cap stocks, especially net of inflation. At the beginning of the period, inflation was in the low single digits and by the end had risen to double digit levels. In contrast to the 1970s, we believe current interest rates and inflation are set to stay low for a long period of time. The economy is still recovering from the COVID-19 recession and the Federal Reserve has indicated that it expects interest rates to remain at zero through 2023. We believe it is expectations for earnings growth from many of the US's largest companies, especially those in technology and tech-based consumer businesses, that has driven Large-Cap stocks above trend.

We continue to like these growth companies, while recognizing that their higher valuations make them more vulnerable to disappointments. If our outlook on either growth for these companies or the outlook for inflation and interest rates changes, then the fact that stocks are starting 33% above trend would increase our concerns about the magnitude of the next bear market.

In conclusion: We believe this is a time where assessing the short and medium-term outlook is more important than making a 10-year forecast. The wide range of potential outcomes discussed in this piece highlights why we believe a multi-faceted approach is warranted. In our view, the Price Matters® framework should be a tool best used in combination with our judgement regarding the outlook for the economy, earnings, and interest rates.

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Market Cap index information calculated based on data from CRSP 1925 US Indices Database ©2020 Center for Research in Security Prices (CRSP®), Booth School of Business, The University of Chicago.

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CRSP ranks all NYSE companies by market capitalization and divides them into ten equally populated portfolios. Alternext and NASDAQ stocks are then placed into the deciles determined by the NYSE breakpoints, based on market capitalization. The series of 10 indices are identified as CRSP 1 through CRSP 10, where CRSP 10 has the largest population and smallest market-capitalization. CRSP portfolios 1-2 represent large cap stocks, portfolios 3-5 represent mid-caps and portfolios 6-10 represent small caps.

RiverFront's Price Matters® discipline compares inflation-adjusted current prices relative to their long-term trend to help identify extremes in valuation.

Index Definitions:

The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services. Indexes are available for the U.S. and various geographic areas. Average price data for select utility, automotive fuel, and food items are also available.

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