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Passing the Baton: 2 Generations, 1 Mission

Reflections on 40 Years of Investing

For years, I have had the pleasure of working with RiverFront's Chairman Rod Smyth, over which we have shaped our philosophies on investing and life. In this *Weekly View*, we wanted to open a window into some of the conversations we have had over the years. I credit Rod as a strong voice who has encouraged RiverFront to adapt both as a global investor and a partner to the advisors we serve. Both Rod and I hope you enjoy the banter and discussion from two veterans of the markets. – *Adam Grossman*

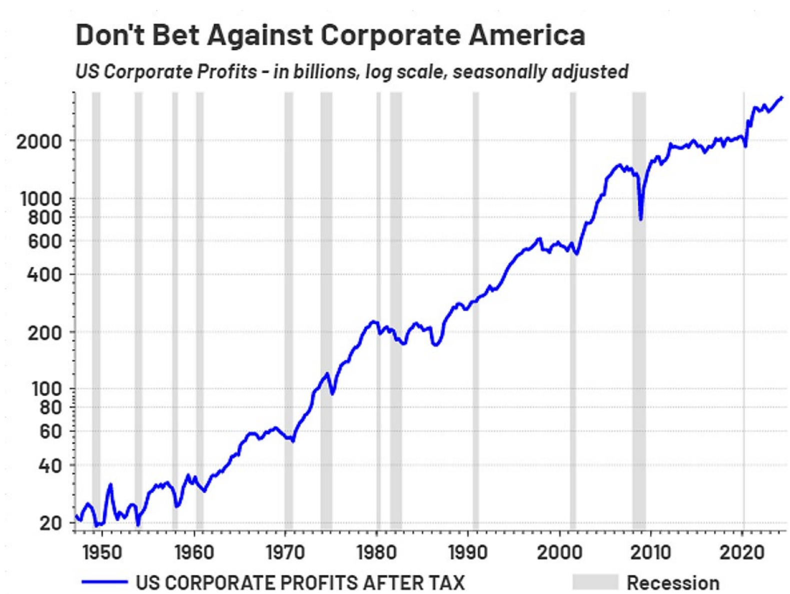
Adam: You are now in your fifth decade of investing in markets around the world. During that time, you have seen an extraordinary amount of upheaval. You've seen different economies structurally change (for better and for worse) and many bubbles build and burst. Can you try to summarize what you have learned?

Rod: Wow, I'll try. If I were to really boil it down, there are four things that stand out to me:

1. **Be an optimist.** Markets go up over time, and change is the only constant.
2. **Trends last…until they don't**, and the consensus is usually wrong at inflection points.
3. **Central bank policy almost always matters**…while politics only matters if it drives sustained policy changes.
4. **Earnings drive returns in the very long term**, while emotion, expressed in the price-to-earnings (P/E) ratio, is one of the biggest drivers of shorter and even medium-term returns.

Adam: Well, covering all of that is probably more likely to be a short book than a long weekly, so let's take them one at a time. Talk to us a little about your concept of optimism and how you think about change.

Rod: Forty years of investing has made me an optimist. Human ingenuity - responsibly constrained by government and incentivized by profit - should not be underestimated. Yet it often is. The Bureau of Economic Analysis (BEA) calculates overall profits in the US economy as part of the GDP statistics. Our chart (right) shows that this measure of profits has risen more than 150-fold, from $22 billion in 1947 to over $3.4 trillion today. In free-market economies, profit growth has led to prolonged stock bull markets in most regions over the last 100 years.



Source: LSEG Datastream, BEA. Data quarterly as of May, 2024. Chart shown for illustrative purposes only. Past performance is no indication of future results.

Humans are hard-wired to worry when it comes to taking risks, which creates opportunity for the optimist. An expression I have always liked is that "Bull markets climb a wall of worry". It's when investors are not worried that I get concerned. One rule that I embraced early in my career is to 'Beware the Crowd at Extremes'. I have lived through major bubbles in Japanese, emerging market and US stocks, as well as a worldwide bubble in real estate. Calling the top of a bubble is almost impossible, but the common characteristic of peaks is an abandonment of caution.

Adam: Over the years, how have you applied your innate optimism to your forecasting?

Rod: Early in my career a big 'Eureka' moment for me was recognizing that successful forecasting was less about the initial prediction and more about how one adapts to new information. Trying to envisage what economies will look like ten and twenty years from now is too challenging to be productive, in my experience. For example, my grandmother was born in 1898 and died in 1991. I often reflect on all the amazing and terrible things she saw in her lifetime, and how she could never have imagined the changes she would see. She lived through two world wars in Europe, Ireland's revolution and eventual independence, electricity, cars, movies, radio and television, airplanes, moon landings and computers to name a few. I now have the chance to reflect on my 63 years. When I think about how all these things changed my grandmother's daily life, I don't feel my everyday life has changed as profoundly. Nevertheless, the advances in technology we have today, from the internet to mobile smartphones and AI, were inconceivable to me in the 1970s and 1980s. **The message is: expect and embrace change.** At RiverFront our philosophy is 'Process over Prediction' and our processes are designed to adapt to changing conditions. Adam, how does this apply to your investing process?

Adam: A lot of your wisdom about not trying to get every call right has undoubtedly had a profound effect on our thinking. While we have made some bold calls (at least in my opinion) over the years, the views that shaped them didn't come all at once like a light bulb going off. Rather, our boldest predictions have come from a "mosaic" approach, where our team patiently put puzzle pieces together until an opportunity eventually revealed itself – it's a lot more perspiration than inspiration. We have all lived through enough market regimes to know that any framework – quantitative or in one's head – has its advantages and limitations. So, there are three principles we think about to form a robust view of a potential investment:

- **Principal #1: Understand history…qualitatively and quantitatively.**
  One of the 'table stakes' of a good investment process is that it must start with being rooted in a study of history, while also understanding that history is unlikely to repeat exactly. Historical study is not only to understand the qualitative facts – what were the policies like in key market episodes - but also to quantify their impacts. We think that blending the "facts" of history and the "numbers" of their impact allows us to extrapolate what might happen in the future. At RiverFront we are lucky to have talented people who are capable of managing large data sets and performing this kind of research, as well as many students of history to understand and place context around the past.

- **Principal #2: Top-down and bottom-up perspectives seldom agree…use that to your advantage.**
  A key feature of our research teams is that we have our top-down 'macro' teams, working somewhat separately from our bottom-up teams. The two processes use vastly different inputs and thinking, and it is seldom that the two approaches reach the exact same conclusion. The benefit of having those two groups work differently is that it provides natural areas for challenge and debate. Our team tries to foster a culture of 'Devil's Advocacy' to help identify blind spots in our thinking. A high-functioning team with multiple perspectives can dive deeper into what might be incongruent between the different models…which is where we think real insights lie.

- **Principal #3: 'Process over prediction' ultimately means leaning into risks that are worth taking.**
  A lot of our top-down research focuses on the magnitude and timing of when we want to allocate to different 'risk premia' based on current valuations and market conditions. Our bottom-up research then works to both corroborate our top-down thinking and identify company or sector specific risk-to-return opportunities. One of the reasons we call our investment approach "Process over Prediction" is because we rely on our processes to make our forecasts. This rigor gives us the flexibility to adapt when our initial prediction is wrong.

Rod: 'Risk Premia' sounds like some serious jargon! Can you give a few examples of what you are talking about?

Adam: Point well taken – 'risk premia' is a fancy word indeed - but I think the concept is easy to understand. Implicit in markets from an asset allocation standpoint is the concept that taking some risks will reward investors with additional returns. For example, the risk premium in stocks and corporate bonds is an excess return that 'pays' investors both for risk of failure of the underlying business, as well as for the volatility of getting to an outcome. Another example is the concept of 'term premium', which is the extra return you get from buying bonds of longer maturity and taking the risk that inflation causes short term interest rates to rise. A lot of our macro work is in establishing the current "value" of these premia, as well as identifying the fundamental catalysts that cause them to rise and fall. To summarize, our long-term research guides our strategic thinking, and we lean on our 'Three Rules' regarding the Fed, the Trend and the Crowd for our tactical (shorter-term) decisions.

Rod: Having developed strategic forecasts, how do you then decide to allocate the money?

Adam: On the selection side, we believe there are certain biases and expectations implicitly baked into current prices. While the tools are a little wonky, we use the current price and a valuation model to essentially "solve" for the market's implied growth rates of a company over the next several years. A lot of the opportunities we see in the market come when we believe investors are either over or under-extrapolating growth. For example, think about how a lot of large technology companies over the last few years consistently appeared "overvalued" looking at their current P/E's, but have continuously been able to grow into these valuations and justify higher prices. In our view, investors failed to see their potential, creating an opportunity. Overseas markets were the opposite. They have looked "undervalued" for a long time, but unfavorable economic conditions and lack of corporate flexibility have led to disappointing earnings. For these reasons, a lot of our research is focused on where the market's view is somehow out of sync with what we think is reasonable.

Rod: That sounds, in many ways, like applying our three tactical rules at the selection level.

Adam: Exactly! I think your wisdom on those topics from a top-down perspective has informed a lot of our innovation in bottom-up research. Let's talk now about your second point regarding trends and the consensus.

Rod: In my experience, the consensus is very influenced by the recent past, often extrapolating the most recent history into the future. This often works well, which is why trend following has been a successful investment strategy and why one of our three rules is 'Don't fight the Trend'. I have often been surprised by how long trends can last. A notable example is the 15-year trend you discussed of outperformance by US stocks over non-US stocks, which would have been hard to envision in 2009.

Just as important is that that outsized returns often happen when structural change gradually or suddenly creates a new consensus. One good example of both a powerful trend followed by a trend change was the handover of economic dynamism from Japan in the 1970s and 80s to the US from the 1990s onward. Japan's recovery from economic destruction in the second World War was remarkable. In the 1970s and 80s Japan grew from a manufacturer of cheap goods to a dominant force in autos, consumer electronics, computers and semiconductors, and its stock market enjoyed several decades of strong growth.

Business schools in the 1980s studied Japanese manufacturing techniques, the yen surged, and Japan aggressively acquired and built assets all over the world. By the mid-1980s Japan seemed an unstoppable economic force and its stock market grew to represent a peak of close to 30% of the entire world index. The consensus at the peak was very optimistic. At the same time, President Reagan was encouraging the beginning of a US revival, viewed skeptically during the early days by the consensus, in my view. By the early 1990s Japan was at the beginning of an unimaginable 30-year secular decline which continues today. In contrast, the US was entering a golden era of innovation, productivity, profit margin growth and stock market gains, the magnitude of which few could have foreseen.

Adam: I think we see a lot of parallels in your macro views that we alluded to in our selection work – the reliance on trends and focusing on catalysts for regime change are evident in both places. We'll have to continue this in another weekly soon – I know there is a lot we can follow up on the 3rd and 4th points you raised in the beginning that will further this conversation.

Rod: Looking forward to it!

Risk Discussion: All investments in securities, including the strategies discussed above, include a risk of loss of principal (invested amount) and any profits that have not been realized. Markets fluctuate substantially over time, and have experienced increased volatility in recent years due to global and domestic economic events. Performance of any investment is not guaranteed. In a rising interest rate environment, the value of fixed-income securities generally declines. Diversification does not guarantee a profit or protect against a loss. Investments in international and emerging markets securities include exposure to risks such as currency fluctuations, foreign taxes and regulations, and the potential for illiquid markets and political instability. Please see the end of this publication for more disclosures.

value of the portfolio may be influenced by currency exchange control regulations. The currencies of emerging market countries may experience significant declines against the U.S. dollar, and devaluation may occur subsequent to investments in these currencies by the portfolio.

Foreign investments, especially investments in emerging markets, can be riskier and more volatile than investments in the U.S. and are considered speculative and subject to heightened risks in addition to the general risks of investing in non-U.S. securities. Also, inflation and rapid fluctuations in inflation rates have had, and may continue to have, negative effects on the economies and securities markets of certain emerging market countries.

Technology and Internet-related stocks, especially of smaller, less-seasoned companies, tend to be more volatile than the overall market.

Index Definitions:

Standard & Poor's (S&P) 500 Index measures the performance of 500 large cap stocks, which together represent about 80% of the total US equities market.

Definitions:

Gross Domestic Product (GDP) is the monetary value of all finished goods and services made within a country during a specific period. GDP provides an economic snapshot of a country, used to estimate the size of an economy and growth rate.

The price-to-earnings ratio compares a company's share price with its earnings per share. Analysts and investors use it to determine the relative value of a company's shares in side-by-side comparisons.

Inflation is a gradual loss of purchasing power, reflected in a broad rise in prices for goods and services over time.

Valuation is the analytical process of determining the current or projected worth of an asset or company. Many techniques are used for doing a valuation. Among other metrics, an analyst placing a value on a company looks at the business's management, the composition of its capital structure, the prospect of future earnings, and the market value of its assets.

Don't Fight the Fed – 'Supportive' means the Fed's monetary policy regarding inflation and employment is in what we believe based on our analysis to be the investors' best interest; 'Against' means the Fed's monetary policy, in our view, is going against the investors' best interest; 'Neutral' means the Fed's monetary policy is neither supportive or against the investors' best interest in our view. Don't Fight the Trend – Terms correlate to the 200-day moving average as it relates to the equity indexes: 'Positive' means that the trend is rising, 'Flat' means the trend is flat, 'Negative' means the trend is falling. Beware the Crowd at Extremes – Terms correlate to the NDR Crowd Sentiment Poll and its measurement of Extreme Optimism (Bearish), Neutral, or Extreme Pessimism (Bullish).

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