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View from the Ranch

Thrice Annual Portfolio Strategy Update from The Rancho Santa Fe Group at Morgan Stanley

At The Rancho Santa Fe Group, all our client portfolio models are reviewed with fitting degrees of scrutiny on an ongoing basis. This includes a daily check, weekly team in depth stock review, monthly systematic risk assessment of stock and bond markets and seasonal trend analysis. Three times a year we methodically review accounts for any significant discrepancies from target asset allocations and rebalance, if needed. We feel that these tri-annual periods also offer a good time for a brief strategy update - a summary of how our team has been positioning your portfolio(s) in the context of prevailing market conditions...

Is Diversification Dead?

The short answer is "No", but 2024 sure felt like diversification was taking a "Sleeping Beauty" sized nap. In our 2024 commentary we called out the "Bad Breadth" that we were seeing in the market. The participation rate of the average company was far weaker than the headline advance in the S&P500. In fact, this poor technical condition continued to concentrate into the few largest companies culminating in December with the worst measurable monthly breadth in history. The concentration in the markets had led us to a point where the entire market capitalization of the S&P500 is dominated by a few technology and tech related companies that now represent 1/3 of the market. Dubbed the "Magnificent Seven" these stocks, and the structural phenomenon they represent, meant that strategies that embrace diversification and rebalancing when weights get excessively concentrated, did not work well. But this is not likely to continue (MS "Case for Diversification" 21JAN2025).

Valuations: When we look at today's valuations in the aggregate stock market, we also find prices extended from historical context. Valuations, in terms of price-to-earnings multiples relative to risk-free interest rates, are in the highest decile, meaning, roughly 90% or more of the time, the stock market has been at better valuations than today. In fact, while we recently have seen new pricing highs in stocks, we have also seen a plateauing, and even some negative revisions in aggregate earnings. In price-to-sales terms, the markets are rivaling the "dotcom" period of 1999-2000. We view the valuation conditions in the market today as a "stretched rubber band"; prices have gone up far quicker than fundamentals (sales and earnings). There is no way to know if this stretched condition will resolve itself with sales and earnings catching up or prices contracting, but we are taught - either outcome could lead to future results that are disappointing relative to recent experience. Given the irrational exuberance led valuation problem is concentrated so much in the tippy-top of the large cap tech universe, there is merit in diversification. Value can be found elsewhere in small companies and stable, dividend focused stocks.

Credit: in 2023 we had six bank failures that were, at least in part, due to an unprecedented rise in rates by the Fed in the periods prior. In urgent response, the Fed and FDIC embarked on newly created bank lending facilities and a temporary

relief of FDIC limits to avoid contagion. These responses may have avoided a domino effect in credit availability and stabilized the lending markets. However, since that time, credit spreads have tightened to a level that doesn't leave a lot of excess interest rate "reward" for the credit default "risk" on the part of lenders (The Great Rate Debate, MS Global Credit Research 17JAN2025). All of this has occurred at the same time we have also seen a massive expansion in non-bank lending in the private credit markets and consumer lending practices like "Buy Now, Pay Later". We see this as another potentially "stretched rubber band". This condition doesn't mean something has to snap, but in our view, relief will require gradual improvement in economic environment and rates if the tension is going to be released smoothly.

Rates: The expectation for further rate cuts in 2025 have narrowed considerably in recent months. The reasons for this are three-fold in our view, a combination of ingredients are getting baked into a new cake. First, optimism that the new administration will usher in a more business friendly and pro growth economy with lower regulations; but with that growth, could come more inflationary pressures. Second, but in contrast, there is another contingent that is concerned that the new policies in the form of tariffs and immigration reform will push up import and labor prices in many industries. And third, there is increasing concern about our country's fiscal discipline and whether the tax reforms being proposed are going to adversely affect our deficit spending. All of these competing forces are inflationary at some level, essentially all pushing in the same direction and are likely to delay the Federal Reserve's ability to achieve their ultimate long run inflation target of 2% (FOMC Statement, 29JAN2025). Obviously, residential and commercial real estate markets are going to be heavily impacted by mortgage and lending rates. Higher rates can put pressure on real estate prices, another source of tension.

So where does all this leave us? On one hand, it means that if the bull market is going to continue, we need new leadership and industries to emerge. On the other hand, if there is any "reversion to the mean" in stock, credit and real estate valuations - if these "stretched rubber bands" snap back to historical norms – then finding some consistency in historically stable business sectors and high-grade fixed income will be at a premium. Both of these possibilities suggest that maximum diversification is warranted.

-Jason Mubarak, CFP®, Executive Director

Yield Focus Models and the *income* component of Balanced accounts.

- We again increased the weighting to bonds given the better interest rate environment and run up in stock prices.
- Within fixed income, with longer rates rising again we have been adding back longer duration and have reduced our client's exposure to the riskier parts of the credit markets.

Blue Chip Model & the *appreciation* component of Balanced accounts.

- We reduced holdings in technology and consumer holdings.
- We added to holdings in healthcare, energy , but continue to maintain a higher-than-normal amount of treasuries and bonds as a reserve for potential future opportunities.

Innovation Portfolio.

- We again reduced holdings in technology.
- We added to positions in infrastructure and also continue to maintain a higher-than-normal amount of treasuries/bonds as a reserve for potential future opportunities.

Strategic Global Asset Allocation

We currently are in a defensive allocation considering:

- Pillar 1: **Relative Valuations** at the global level are rich by historical standards and bond yields are still near multi decade highs
- Pillar 2: **Technical Conditions** have broken down somewhat recently and we continue to see signs that complacency, FOMO (Fear Of Missing Out) and "greed" are psychological factors driving investor sentiment.
- Pillar 3: We believe **Credit Risk** is starting to show a deteriorating trend.

Dividend Growth

- The Dividend Growth portfolio is a low turnover set of global stocks with stable and consistent dividend payout records. We do not anticipate changes to this basic underlying approach.
- The universe of dividend paying companies has come back into favor as the anticipation of further interest rate cuts have attracted investors interested in cash flow back to this subset of the market of high-quality companies.
- Specifically, we again reduced sector exposure in financial companies and capital markets in favor of more defensive sectors such as consumer staples and health care.

Tactical

- We have added back stock holdings during this historically seasonal strong time of year but still are not fully invested due to credit and valuation conditions. Clients in the Tactical portfolio can look forward to a monthly email for more timely updates.

Mo-44

- As our most aggressive growth-oriented Portfolio Management strategy, The Momentum-44 portfolio, typically is fully invested in equities across the market capitalization spectrum in companies we feel exhibit appreciation opportunities, sound technical conditions and a favorable trend in analyst revisions.
- However, the run up in prices, particularly in 2024, has left us with fewer reinvestment opportunities that make analytical sense from a risk/reward perspective. As a result, we have been forced to park some funds in short term treasuries until better opportunities arise. This positioning can change quickly in this portfolio but for now we will be patient until fundamentals or prices change.
- Within the stock holdings, the largest holdings are within the technology, financials and health care sectors.

Special Opportunities

- As our small-midcap appreciation mix, we continue to look for companies with high quality growth characteristics over a longer time horizon.
- Currently, our largest holdings are within the technology and health care sectors.

"Consistent Stewardship in a Changing World"

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