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PERSPECTIVES

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A Strong November & December Raise Stock Asset Class Valuations Significantly

Despite a rough October, the last quarter of 2023 ended up delivering stellar returns. In this issue of *Perspectives*, I'll review the historical returns of various indexes and certain funds. I will then provide an update on valuation levels and expected long-term returns for equities (stocks, stock mutual funds).

ASSET CLASS or INDEX	(1 YEAR) 2023 Returns	(3 YEARS) 2021-2023 Average Annualized Returns	(5 YEARS) 2019-2023 Average Annualized Returns	(10 YEARS) 2014-2023 Average Annualized Returns	(20 YEARS) 2004-2023 Average Annualized Returns	(25 YEARS) 1999-2023 Average Annualized Returns	(30 YEARS) 1994-2023 Average Annualized Returns
U.S. LARGE COMPANY STOCKS							
S&P 500 Index®	26.29%	10.00%	15.69%	12.03%	9.69%	7.56%	10.15%
Russell 1000 Index®	26.53%	8.97%	15.52%	11.80%	9.78%	7.72%	10.18%
DFA US Large Company Portfolio (DFUSX)	26.25%	9.92%	15.63%	11.97%	9.67%	---	---
U.S. LARGE COMPANY VALUE STOCKS							
S&P 500 Value® Index	22.23%	13.11%	14.11%	10.01%	8.52%	7.17%	---
Russell 1000® Value Index	11.46%	8.86%	10.91%	8.40%	7.99%	7.09%	9.27%
DFA US Large Value Portfolio (DFLVX)	11.47%	10.39%	10.90%	8.33%	8.60%	8.19%	9.75%

Past performance is not a guarantee of future returns.

Please see important disclosures and sources of data, on a page following.

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U.S. SMALL COMPANY STOCKS							
Russell 2000 Index®	16.93%	2.22%	9.97%	7.16%	8.11%	7.91%	8.56%
S&P 600 Index®	16.05%	7.28%	11.03%	8.66%	9.65%	9.66%	10.25%
Dimensional Small Cap Portfolio (DFSTX)	17.64%	9.93%	12.45%	8.07%	9.11%	9.71%	10.11%
U.S. SMALL CAP VALUE STOCKS							
Russell 2000 Value Index®	14.65%	7.94%	10.00%	6.76%	7.68%	8.58%	9.33%
S&P 600 Value Index®	14.89%	10.20%	11.31%	8.17%	9.11%	9.49%	--
Dimensional Small Cap Value Portfolio (DFSVX)	18.91%	17.07%	14.14%	7.99%	9.00%	10.54%	11.14%

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FOREIGN DEVELOPED MARKETS EQUITIES							
MSCI EAFE Index	18.85%	4.53%	8.69%	4.78%	6.08%	4.89%	5.64%
MSCI EAFE Large Value Index	20.51%	9.53%	8.28%	3.70%	5.19%	4.82%	---
DFA International Value Portfolio (DFIVX)	17.79%	10.51%	8.84%	4.15%	6.08%	6.10%	---
DFA International Small Cap Value Portfolio (DISVX)	17.58%	7.13%	8.44%	4.62%	7.72%	8.98%	---
FOREIGN EMERGING MARKETS EQUITIES							
MSCI Emerging Markets Index	10.27%	-4.71%	4.07%	3.05%	7.20%	7.88%	4.81%
DFA Emerging Markets Value Portfolio (DFEVX)	16.49%	5.34%	5.66%	3.74%	8.25%	9.72%	---
MSCI Emerging Markets Small Cap Index	24.49%	6.99%	10.41%	5.74%	8.95%	8.71%	---
DFA Emerging Markets Small Cap Portfolio (DEMSX)	16.31%	4.13%	8.10%	5.55%	9.30%	10.65%	---
MSCI Emerging Markets Small Value Index	24.81%	8.97%	10.33%	6.56%	10.37%	11.11%	---

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SCHOLAR FINANCIAL, LLC

Holistic investment and financial advice for executives, accumulators, and retirees.

Prudent portfolio management for trustees, foundations, and endowments.

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Past performance is not a guarantee of future performance. Data represents the returns of various indexes, Dimensional Funds Advisors mutual funds and ETFs, in each broad asset class. Within each asset class are varying degrees of exposures to the profitability, value, size, investment, and momentum factors. **You cannot invest directly in an index, and index returns do not reflect mutual fund / ETF fees (annual expense ratio), nor do they reflect internal transaction and opportunity costs within the fund relating to transactions of securities within the fund and/or the presence of cash holdings.** Data provided through DFA Returns Web program and is believed to be accurate but cannot be guaranteed.

Fund, ETF, and index returns do not reflect any deduction for the fees that are charged or would have been charged by Scholar Financial, LLC, nor any transaction costs which may be incurred with a custodian (i.e., Charles Schwab, etc.). Fund, ETF and index fund returns are also presented pre-tax (*i.e*., no adjustment is made for the impact of federal, state or local income taxes that might be incurred by the owner (taxpayer), nor for tax credits that may be available when foreign securities are held by a mutual fund or ETF).

The mutual funds and ETFs set forth in the tables above are not necessarily recommended by Scholar Financial, LLC, and the historical returns are presented solely for educational purposes. Be aware that other mutual funds (such as Dimensional Fund Advisors' "core equity" and "targeted value" funds and ETFs, which possess exposures to multiple "factors" with on average lower portfolio turnover levels and lower annual expense ratios) are often recommended by Scholar Financial, LLC to its clients, but such funds often possess exposures to multiple asset classes.

VALUATIONS AND EXPECTED LONG-TERM RETURNS: EQUITIES

I again present data from Research Affiliates, a firm that does, in my view, an exceptionally good quantitative analysis of the valuations of various equity (stock) asset classes. Below is a chart setting forth data from Research Affiliates, as of December 31, 2023. With stock asset class returns generally negative during the month of October, I also show the impact of the fall of stock prices by showing the increase in the expected returns (mean projection), from the September 30, 2023 data.

Additionally, I set forth additional asset class return projections from my own computations (for U.S. stock asset classes only).

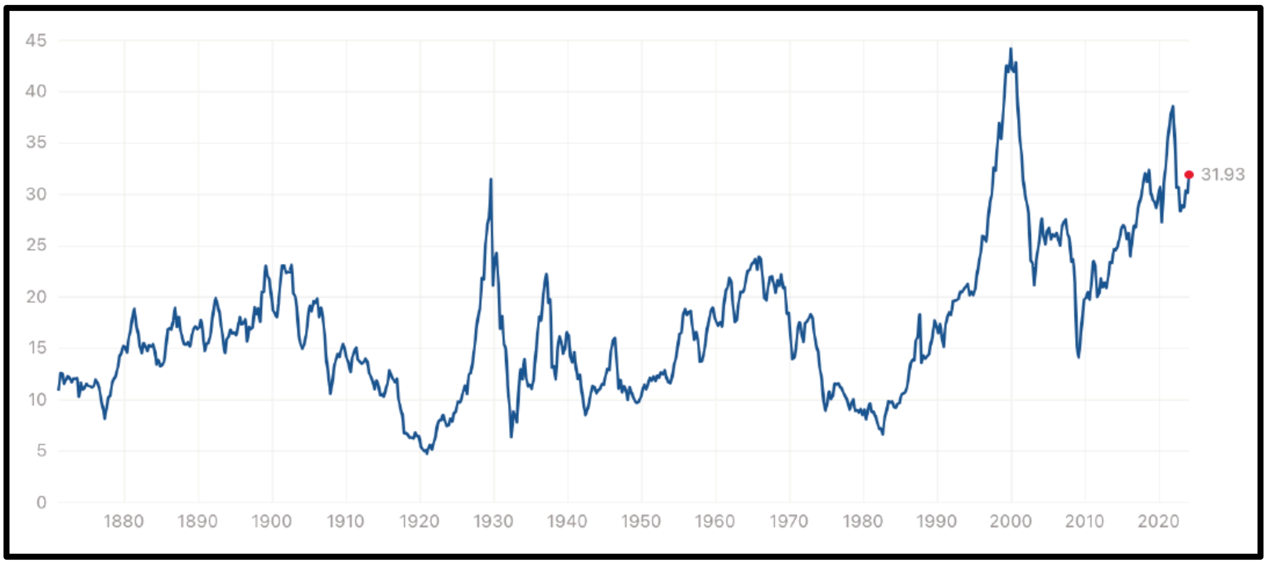
ASSET CLASS	As of December 31, 2023, Expected 10-Year Nominal Average Annualized Returns Per Research Affiliates' Asset Allocation Interactive Calculations			As of Dec. 31, 2023, Expected 10-Year Nominal Average Annualized Returns (Ron Rhoades' Calculations)
	5% probability of returns less than:	**Mean Projection of Expected Returns:**	5% probability of returns greater than:	
U.S. large company growth stocks	-3.6%	**2.8%**	9.2%	**3.0%**
U.S. large company stocks	-1.8%	**4.0%**	9.7%	**5.1%**
U.S. large company value stocks	0.5%	**6.3%**	12.1%	**5.4%**
U.S. small company growth stocks	-3.4%	**4.7%**	12.8%	**3.1%**
U.S. small company stocks	-0.5%	**7.2%**	14.8%	**7.4%**
U.S. small company value stocks	0.8%	**8.4%**	16.0%	**9.1%**
Developed markets (ex-U.S.) stocks	2.8%	**9.0%**	15.2%	---
Developed markets (ex-U.S.) value stocks	4.3%	**10.8%**	17.3%	---
Developed markets (ex-U.S.) small company stocks	3.4%	**10.2%**	17.0%	---
Developed markets (ex-U.S.) small company value stocks	5.2%	**11.8%**	18.4%	---
Emerging markets stocks	2.3%	**9.9%**	17.5%	---

See Important Disclosures and Sources of Data on a Subsequent Page

As shown in the prior chart, Research Affiliates projects relatively low returns over the next 10 years for both U.S. large cap growth stocks and U.S. small cap growth stocks. As well as for U.S. large company stocks, overall, which account for about 85% of the total value of U.S. publicly traded stocks. Research Affiliates projects generally higher returns for foreign developed markets stocks and emerging markets stocks. Also, value stocks are likely perform well, over the long term, whether in large cap or small cap asset classes, and whether in the U.S. or in foreign markets.

Using Ron's methodology, which is based upon price-book valuation ratios for U.S. stock asset classes, using historical data from the Russell 2000 indexes and contrasting such with data from the Fama/French indexes and other sources, it appears that at present only U.S. small company value stocks are reasonably valued at present. In contrast, all other asset classes shown for U.S. stocks appear to be overvalued, with growth stocks being significantly overvalued.

Turning to another measure of the valuation levels of the broad U.S. stock market, **the S&P 500 Shiller CAPE Ratio, also known as the Cyclically Adjusted Price-Earnings ratio**, is defined as the ratio of the S&P 500's current price divided by the 10-year moving average of inflation-adjusted earnings. The metric was invented by American economist Robert Shiller and has become a popular way to understand long-term stock market valuations. It is used as a valuation metric to forecast future returns, where a higher CAPE ratio could reflect lower returns over the next couple of decades, whereas a lower CAPE ratio could reflect higher returns over the next couple of decades, as the ratio undertakes a reversion to the mean.



As of close of trading on January 3, 2024, the ratio stood at **31.93 - much higher than its mean (since 1870) of 17.07**. However, various studies of p/e ratios utilization in valuations have suggested that a "normal" level of the CAPE ratio for the S&P 500 Index should lie between 20 and 25, due to changes in accounting policies and for other reasons. Still, the CAPE ratio suggests an overvaluation for U.S. large company stocks of 20% to 50% at the present time.

The S&P 500 Index® Price-Sales Ratio can also be utilized to discern valuation levels. Price-to-sales for the S&P 500 Index, an index of the stocks of 500 very large companies with headquarters in the United States, also avoids distortions from fluctuating profit margins. Values above the long-term average of 1.70 warn that stocks are highly priced, while lower values indicate underpricing. As of January 3, 2024, the price-sales ratio for the S&P 500 Index® stood at 2.59, well above the long-term average.

The Buffett Indicator (also known as the Buffett Index or Buffett Ratio) is the ratio of the total United States stock market to GDP. Values above the long-term average of 1.03 warn that stocks are over-priced, while values below that indicate stocks are under-priced. As of January 2, 2024, the ratio is calculated as **1.73** - which is said to be in the "significantly overvalued" range, resulting in expected returns for U.S. stocks being in the low single digits for the next 10-year period, assuming mean reversion occurs over that period. Again, the primary cause of this overvaluation is U.S. large company growth stocks being overvalued at present.

CAVEATS ABOUT VALUATION MEASURES

Again, I want to emphasize that there is *nothing certain* in the data presented above. Indeed, there is a broad range of possible outcomes, wholly dependent upon economic growth in various countries, changes in tax and other policies, and the endpoint (10 years from now) in valuations. Rarely does the endpoint attain reversion to the exact mean, as predicted in the "mean projection of expected returns" column in the foregoing chart.

In other words, estimates of future stock returns are just that – estimates. There is a broad range of potential returns, and the "mean" return that is shown, while indicative of the best guess, is still a guess made through the lens of a *very cloudy* crystal ball. All this means that diversification among asset classes – and among the world's various capital markets – remains a key tenet for investors.

There is no perfect, or even exceptionally great, method of undertaking projections of future returns. For example, the mean of valuation ratios changes over time, whether due to changes in corporate policies, the need for capital assets, or long-term changes in the perceptions of investors as to market or other risks. Additionally, once a factor is widely known, some evidence suggest that investors react to the knowledge of the factor by adjusting valuation ratios, although this adjustment is not full (and perhaps less than 50% of the expected excess returns of a factor). Macroeconomic factors, including long-term changes to tax policies, the impact of technology (robotics, computer software including artificial intelligence, etc.), can possess a tremendous impact on the profitability of certain industries in the future, often in unpredicted ways.

But, despite the uncertainty, it is good to have a likely statistical advantage. In other words, over the next 10 years, evidence-based equity investing, and particularly the value stock strategy and the multi-factor stock strategy – implemented through low-cost, low-relative-turnover and highly diversified portfolios, looks highly appealing.

In contrast, the S&P 500 Index®, which is followed (and invested in) by many investors, looks likely to underperform its historic average annualized return (since 1926) of between 9% and 10% (on average, over very long periods of time), and possesses an expected (median) average annualized return of only about 4% to 5% over the next 10 years.

IMPORTANT DISCLOSURES REGARDING ESTIMATES OF FUTURE RETURNS.

These are estimates, or projections, only, and are NOT a guarantee of any future returns. There is a distinct possibility that the returns of one or more of the asset classes may be significantly lower, or significantly higher, than the range of estimates provided for that asset class, as set forth above. **Past performance is not a guarantee of future returns.**

Stock returns can be affected by many factors, including but not limited to changes in valuation levels with ending results significantly above or below the historical average levels, changes in tax policies, changes in interest rates, changes in the rate of inflation, changing investor perceptions and appetites for risk, and many different macroeconomic factors. All the returns shown are gross nominal expected returns, prior to any deduction for mutual fund / ETF or other fees, expenses, transaction and opportunity costs within a fund, and the fees of any separate (from the fund) investment adviser, such as the fees that would be charged by Scholar Financial, LLC. Nominal returns do not reflect the impact of inflation rates. Nominal returns also do not reflect the impact of taxes which may occur, depending upon the type of account in which the investments are held, along with other factors. **You cannot invest directly into an asset class or index**; investments must be made by purchasing securities (individual securities, mutual funds, ETFs, etc.), which incur costs.

SOURCE OF DATA: Research Affiliates, Asset Allocation Interactive (as of Dec. 31, 2023). Please note that the outcomes stated are hypothetical in nature, and that neither Research Affiliates nor its Asset Allocation Interactive tool, in presenting this data, is recommending any specific securities (stocks, bonds, funds, etc.). For more disclosures, please refer to Research Affiliates' methodology and legal web pages. You acknowledge your access to and understanding of these disclosures and disclaimers with respect to the Research Affiliates activities, including with respect to the document, information or that linked to these disclosures and disclaimers.

SOURCE OF DATA: Ron Rhoades of Scholar Financial, LLC, using proprietary data set employing a mix of data from Russell indices, Fama/French research indices (with adjustments for implementation costs), actual returns from 8/1996-12/2023 of DFA US Large Cap Value, DFA US Small Cap, and DFA US Small Cap Value portfolios (mutual funds), and price-book ratios of iShares ETFs that track the Russell indices. Adjustments are then undertaken to future expected returns (in contrast to historic returns) because of lower working-age population growth in the U.S., as well as greater consumer and government debt levels, which will each likely serve as drags upon U.S. economic growth and, hence, equity returns. Additional adjustments are made to small cap and value returns due to greater utilization among funds and practitioners of these factors, which tends to lower expected returns.

In Conclusion

Late 2023 saw growth stocks once again lead the way. While some might opine that investing has changed, with the rise of mega-corporations, and that "this time it's different," such words are dangerous, in my view. Regardless of the evolution of business strategies, fundamentals continue to matter. One aspect of this is valuations … they continue to matter, at least in the long run.

Due to the present relative valuations between growth stocks and value stocks, a multi-factor approach, employing the size factor (small-cap risk premium), price factor (value risk premium), profitability factor (or its cousin, the quality factor, which is defined in different ways), and aided possibly by other factors, possesses a very strong probability of outperforming broad market funds over the next 10 to 20 years. As discussed in prior editions of this newsletter, the employment of multiple factors (selected for their academic support) when designing overall investment strategies will tend to smooth out performance when any one factor disappoints.

Yet, there are very, very few investment strategies that are strongly supported by the academic evidence. While there are many hundreds of "factors" – less than a dozen have received widespread academic support for being robust, relatively persistent, and investable.

A disciplined approach, employing strategic asset allocation, periodic rebalancing, an attention to valuation levels, and other attributes of evidence-based investing, should pay off handsomely in the long run, given the overvaluation of growth stocks currently.

Dr. Ron A. Rhoades serves as Associate Professor of Finance and Director of the Personal Financial Planning Program within the Gordon Ford College of Business at Western Kentucky University. He teaches and has taught courses in Retirement Planning, Applied Investments, Advanced Investments, Estate Planning, Financial Plan Development, Personal Finance, Money & Banking, Legal and Regulatory Aspects of Personal Financial Planning, Risk Management and Insurance, and Principles of Finance. He is regarded as a national expert in the application of fiduciary duties to the delivery of investment and financial planning advice. Ron's upcoming book, *Mastering the Science and Art of Investing: Strategies for Maximizing Returns with Multi-Factor Portfolios*, is anticipated to be published in 2024.