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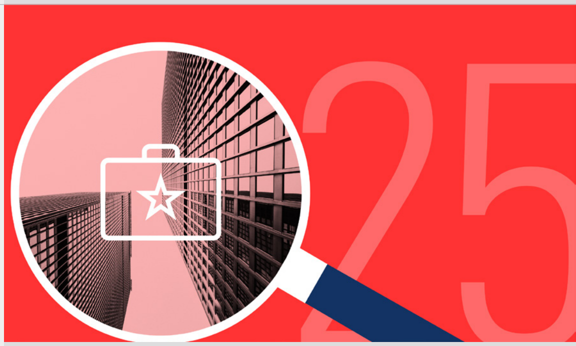
Hunting for Value in an Expensive US Stock Market



US stock valuations are elevated, suggesting a need for greater defensiveness in portfolio positioning, but not a reason to exit the US market entirely. Historically, exiting the market has often led to missed opportunities, either from continued gains or failure to re-enter at the right time. Instead, it’s about balancing behavior, calibrating between caution and aggressiveness to navigate current conditions wisely.

Key Takeaways

+ Long-term investment opportunities in the US are becoming increasingly scarce.
+ Lower valuations and expectations offer potential opportunities in the value segment.
+ Small caps and consumer staples appear to be worthy of consideration into portfolios.
+ Diversifying portfolios within US equity can help investors safeguard against potential leadership shifts in the market.

Warren Buffett likes cash more than ever and many are interpreting it as an ominous signal.

Berkshire's latest earnings reveal that the company now holds over $325 billion in cash and cash equivalents—primarily short-term Treasuries—more than double its cash holdings from a year ago.

This has fueled speculation, with questions like, "Is Buffett bearish on US stocks?"

While we're unlikely to receive a direct answer, it's fair to suggest that Buffett sees fewer attractive opportunities. He's a disciplined, valuation-based investor, and let's face it—valuations are far from cheap.

One indicator, the CAPE Ratio, shows US equity valuations are at their highest since the late 1990s, sitting at 38.1 and placing it in the 98th percentile of historical readings.

Without speaking for him, this valuation data isn't a well-kept secret and likely factors into his growing cash position.

Exhibit 18: CAPE Ratio: US Large Cap Stocks

Source: Robert Shiller Data Library. Observation period = Jan. 1945 – Nov. 2024.

Buffett's Moves Not Relevant for All Investors

One way Buffett has been building his cash reserve is by reducing his stake in Apple.

Yet an often-overlooked detail here is Apple's valuation since his first purchase. When Buffett initially invested in Apple in early 2016, the stock was trading at 10 times earnings; today, it trades at 31 times earnings.

In other words, Buffett's doing what he's always done—buying cheap and selling dear.

While Buffett's approach is shrewd, it's worth cautioning that average investors might misinterpret his actions without considering the broader context. Managing hundreds of billions of dollars, as Buffett does, means there are only a few companies big enough to significantly impact his portfolio.

Apple was one such "needle mover," being the world's largest company with a reasonable valuation when he bought it.

Today, similar opportunities are scarce—at least in Buffett's view—hence the growing cash reserves. But this logic doesn't necessarily apply to other investors.

Put simply, while there may be fewer attractive investment opportunities in the US, that doesn't mean they're nonexistent either.

With that in mind, let's explore three US investment themes that we believe hold strong potential for 2025.

Theme #1—Large Cap Value

Valuations within US large caps tell a story of two distinct markets:

1. A high-valuation (expensive) segment, which has fueled most of the recent performance and captures the bulk of media attention.
2. A low-valuation (cheaper) segment, which has been largely overlooked.

To illustrate, consider underlying data from Morningstar indexes: The top 10 holdings in the large-cap growth index trade at an average price-to-earnings ratio of 41.9, while the top 10 holdings in the large-cap value index trade at a much lower 18.4.

Exhibit 19.1: Top 10 Holdings (Morningstar US Large Growth)

Company	Ticker	P/E
Nvidia NVDA	NVDA	37.2
Microsoft	MSFT	31.5
Amazon	AMZN	33.0
Tesla	TSLA	102.0
Salesforce	CRM	29.2
Visa	V	27.4
Netflix	NFLX	36.9
Mastercard	MA	31.4
Airbnb	ABNB	29.0
ServiceNow	NOW	60.6
	Avg. P/E	**41.8**

Exhibit 19.2: Top 10 Holdings (Morningstar US Large Value)

Company	Ticker	P/E
Berkshire Hathaway	BRK.A	23.6
JPMorgan Chase	JPM	14.4
Exxon Mobil	XOM	13.5
Home Depot	HD	25.3
Johnson & Johnson	JNJ	14.3
AbbVie	ABBV	14.1
Walmart	WMT	31.8
Bank of America	BAC	12.5
Coca-Cola	KO	21.2
Chevron	CVX	13.3
	Avg. P/E	**18.4**

Source: Morningstar Direct, Morningstar Indexes. Data as of November 21, 2024.

When assessing index-level valuations, many investors stop at the headline number. However, a deeper look reveals intriguing insights. Specifically, within the value segment of the index, significantly lower valuations—and expectations—become evident.

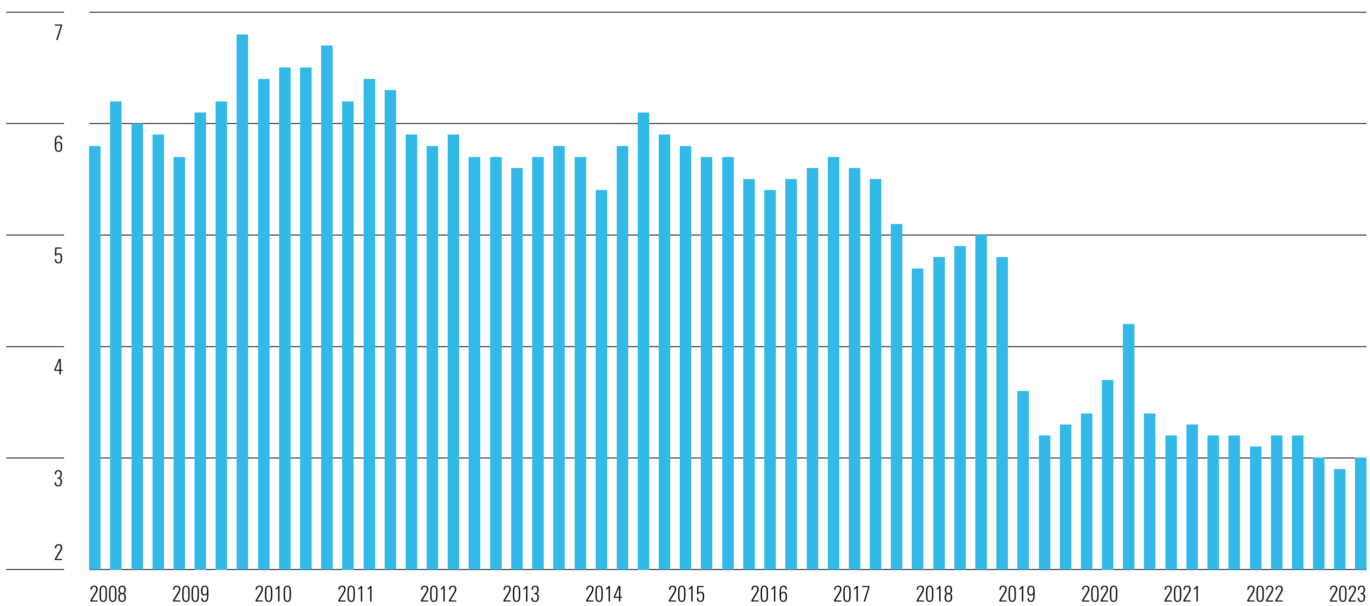
Theme #2—Small Caps

One reason to own asset classes others ignore is that even a small amount of positive news can quickly shift sentiment.

Small caps are a prime example. Large pools of investor capital have largely ignored small caps, and for valid reasons—most notably, their underperformance relative to large caps. Additionally, rising interest rates have compounded the pressure, as small caps typically carry more floating-rate debt, which becomes costlier as rates climb.

We often describe small caps with "The Three U's": unloved, underperforming, and undervalued.

Exhibit 20: Small-Cap Weighting as % of Total Holdings for Multi-Asset Managers



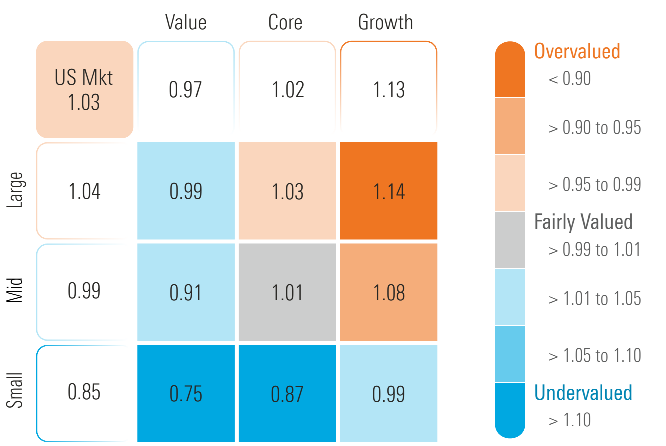
Source: Bank of America US Equity Strategy Research. FactSet.

Small caps are undeniably unloved—interest from active managers appears to be in a perpetual state of decline. Per Bank of America research, small caps now make up just 3% of active portfolios, a figure that has halved over the past decade.

The underperformance has been well documented. Large caps have outpaced small caps, outperforming them in nine of the past 10 calendar years.

When apathy and poor returns intersect, they create a potent mix that often leads to an asset class becoming undervalued. According to Dave Sekera, Morningstar's Senior US Market Strategist, small-cap stocks are currently trading at a 15% discount to fair value, making them the cheapest US asset class across the style box.

Exhibit 21: Price/Fair Value by Morningstar Style Box Category



Source: Morningstar. Data as of September 23, 2024.

While many investors may dismiss small caps, the setup is becoming increasingly compelling.

For one, small caps broke out to new 52-week highs in March of this year and have continued to reach new all-time highs throughout the year. Although some may hesitate to invest at all-time highs, one simple investing principle is that strength begets strength—meaning it's not uncommon for an asset class that has performed well to continue that momentum.

As we've mentioned before, all-time highs are nothing to fear. In fact, quite the opposite.

Exhibit 22: Small Cap Forward Returns Post Rate Cut

First Rate Cut	**3 Months**	**6 Months**	**1-Year**	**3-Year**	**5-Year**
5/30/1980	23.0%	40.6%	53.3%	29.5%	16.2%
11/2/1981	–5.2%	–5.9%	11.7%	11.7%	13.6%
11/21/1984	17.8%	16.3%	22.2%	4.4%	10.7%
6/6/1989	3.4%	–2.4%	–1.2%	4.9%	8.0%
7/6/1995	5.6%	9.4%	20.2%	18.5%	14.3%
9/29/1998	12.5%	9.7%	16.8%	4.8%	7.2%
1/3/2001	–11.8%	3.1%	3.8%	6.5%	8.2%
9/18/2007	–6.2%	–14.9%	–15.0%	–5.6%	2.8%
7/31/2019	0.2%	5.5%	–3.7%	7.5%	8.7%
Average	4.4%	6.8%	12.0%	9.1%	10.0%
Median	3.4%	5.5%	11.7%	6.5%	8.7%
% Time Positive	**66.7%**	**66.7%**	**66.7%**	**88.9%**	**100.0%**

Source: Ned Davis Research, Bloomberg, Patient Capital Mgmt. Russell 2000 Index used for analysis. Past Performance no guarantee of future results.

Secondly, rate cuts are generally favorable for small caps. Historically, after the initiation of a rate-cutting cycle, small caps have posted positive returns nearly 70% of the time, with an average return of 12.0% one year later. Over a five-year period, small caps have been positive 100% of the time.

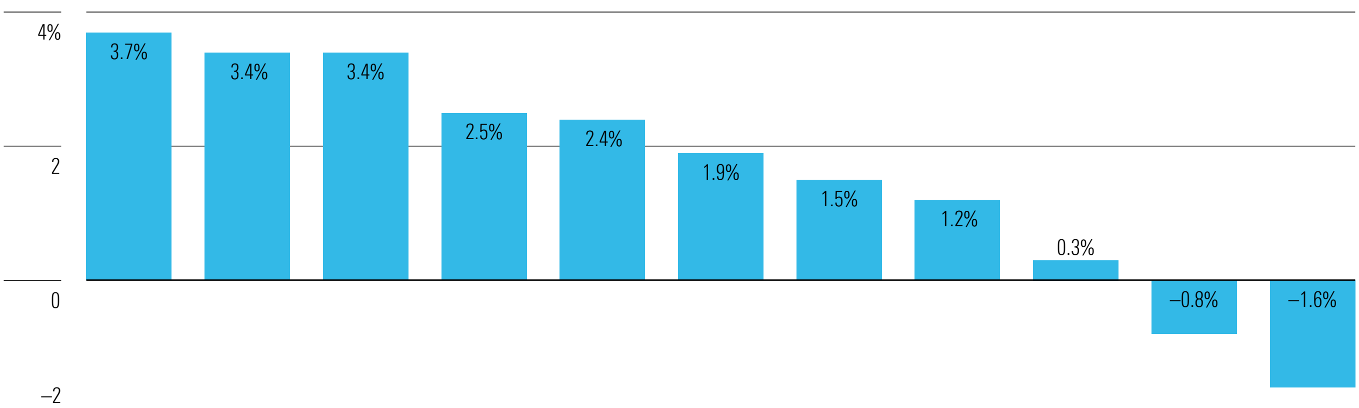
We also see an opportunity to apply a quality filter within small caps. For instance, nearly 25% of the broad small-cap index consists of unprofitable companies. By focusing on the higher-quality, more profitable segment of the asset class, investors can potentially build a more resilient small-cap portfolio, rather than simply buying the index as a whole.

Theme #3—Consumer Staples

The final US investment idea focuses on a sector: Consumer staples.

The consumer staples equity sector includes companies that produce essential goods and services—such as food, beverages, household items, and personal care products—that remain in demand regardless of economic conditions. This sector includes major multinational companies like Walmart and Procter & Gamble at one end of the spectrum, down to Lamb Weston—one of the largest sellers of French fries in the world—and everything in between.

Exhibit 23: Expected Returns (10-Year Annualized)

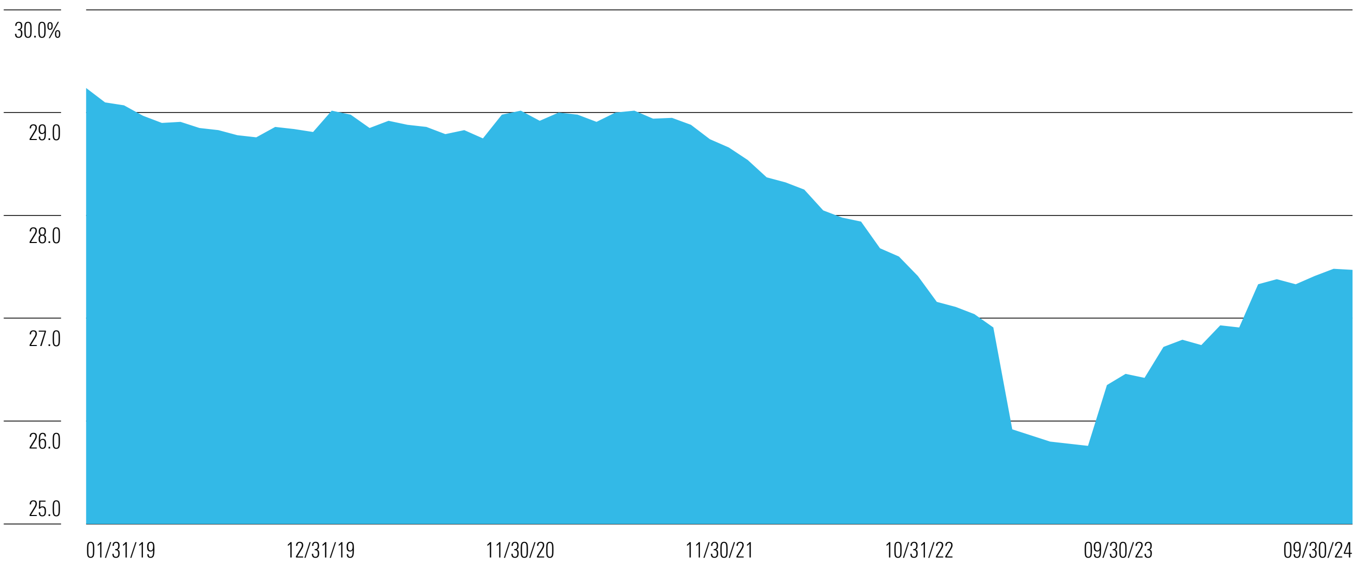


Source: Morningstar Investment Management. Data as of October 31, 2024.

The investment thesis for consumer staples is grounded in the following:
Our proprietary valuation research, which incorporates several factors, identifies consumer staples as having the most attractive forward-return prospects among all US sectors.

Consumer staples were hit harder than other sectors by inflation and supply chain disruptions, and the market took notice, resulting in underperformance in previous years. However, profit margins bottomed out in 2023 and have started to recover gradually and consistently, a trend we believe will continue.

Exhibit 24: Gross Margins—Consumer Staples



Source: Morningstar. Jan. 2019—Nov. 2024.

Lastly, the impact of GLP-1 drugs has loomed large over the sector. Apart from artificial intelligence, it's hard to find a growth area bigger than weight loss drugs, as evidenced by the success of Eli Lilly.

Conventional wisdom suggests that companies like Walmart and Pepsi would see reduced sales as people get slimmer. However, conventional wisdom isn't always accurate, and recent commentary from major consumer staples companies challenges this narrative.

Markets often climb a wall of worry, and the concerns within the staples sector have generated enough pessimism to create potential opportunities for contrarian investors.

Exhibit 25: Weight Loss Drugs *Weighing* on Consumer Staples?

Largest retailer in the world:
Walmart

Largest grocery store operator in the US:
Kroger

Manufacturer of beer cans:
CROWN
Brand-Building Packaging™

Seller of soft drinks and snacks:
PEPSI

Largest chocolate seller in the US:
HERSHEY'S

With an Eye Towards '25

Instead of chasing the "Magnificent 7," investors may be better served by ensuring broad diversification, positioning themselves to benefit from companies that could be tomorrow's leaders.

We believe opportunities remain in the US market if you're willing to dig for them.

And while the opportunity set may be shrinking for the world's greatest investor, this is largely due to the sheer size of Buffett's capital—finding impactful opportunities becomes challenging when managing over $300 billion.

For the average investor, however, this constraint doesn't apply, and it's worth keeping this difference in mind when evaluating today's US investment landscape.

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