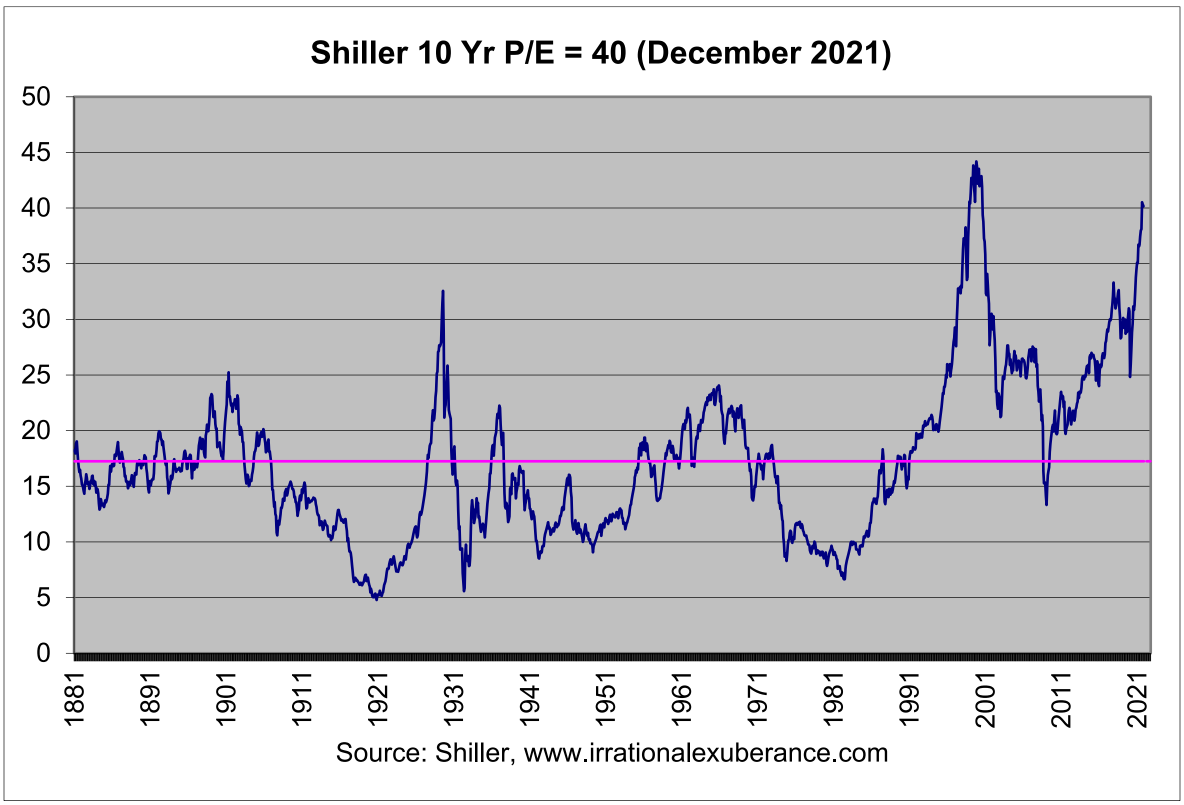
PARAGON INVESTMENT STRATEGY

January 2022

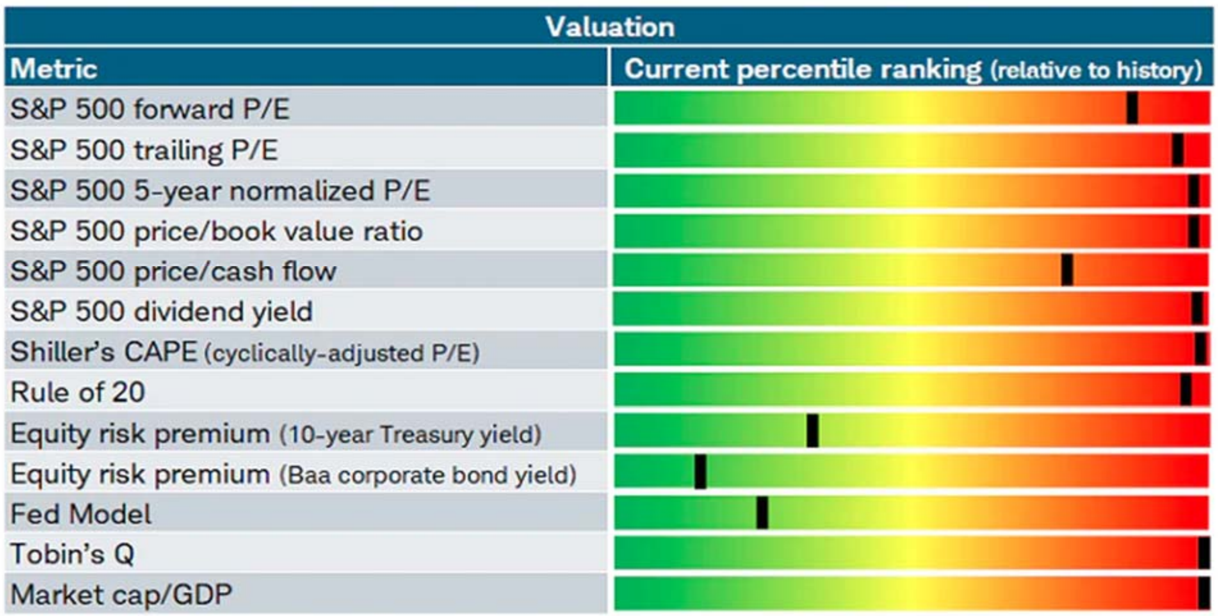
Our investment strategy includes the following recommendations:

1. Overweight international stocks relative to domestic stocks.
2. Include significant allocation to small company stocks.
3. Focus on cheaper "value" stocks and high-quality companies; underweight high-valuation stocks.
4. We prefer high-quality, short-to-intermediate duration bonds.

High Valuations: One common theme among these strategies is that valuations are historically high, with one popular valuation measure being the 10-year Price/Earnings ratio. Also known as the Shiller P/E Ratio, or the Cyclically Adjusted Price-to-Earnings (CAPE) ratio, it's a measure of value that divides the current price by the 10-year average of inflation-adjusted earnings per share. December's ratio of 40 has only been surpassed in the late 1990s dot-com bubble, as seen in the 150-year chart below.



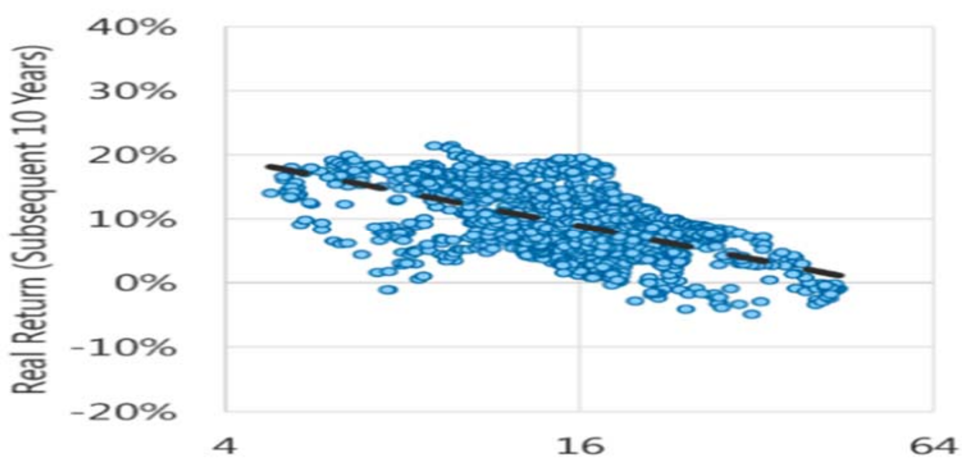
Some of the increase in valuations is justified by changes in the economy over the years, such as more services/less manufacturing, less cyclical companies with higher cash flows, and accounting changes that result in lower earnings. While the CAPE measure has some flaws, most other valuation metrics are showing a similar pattern, as indicated below. Historically low interest rates have also contributed to higher valuations, as the valuations metrics in green are all interest rate based.



Source: Charles Schwab, Bloomberg, The Leuthold Group, as of 10/29/2021. Due to data limitations, start dates for each metric vary and are as follows: CAPE: 1900; Dividend yield: 1928; Normalized P/E: 1946; Market cap/GDP, Tobin's Q: 1952; Trailing P/E: 1960; Fed Model: 1965; Equity risk premium, forward P/E, price/book, price/cash flow, rule of 20: 1990. Percentile ranking is shown from lowest in green to highest in red. A higher percentage indicates a higher rank/valuation relative to history.

Low Expected Returns: While not predictive at all in the short term, high valuations lead to lower long-term returns. As shown below, the current valuation level implies annualized returns in the low single digits (after inflation) over the next decade, or 5% before inflation.

P/E Ratio vs Subsequent Returns



Shiller 10-Year P/E Ratio

Source: Research Affiliates, LLC, using data from Robert Shiller database

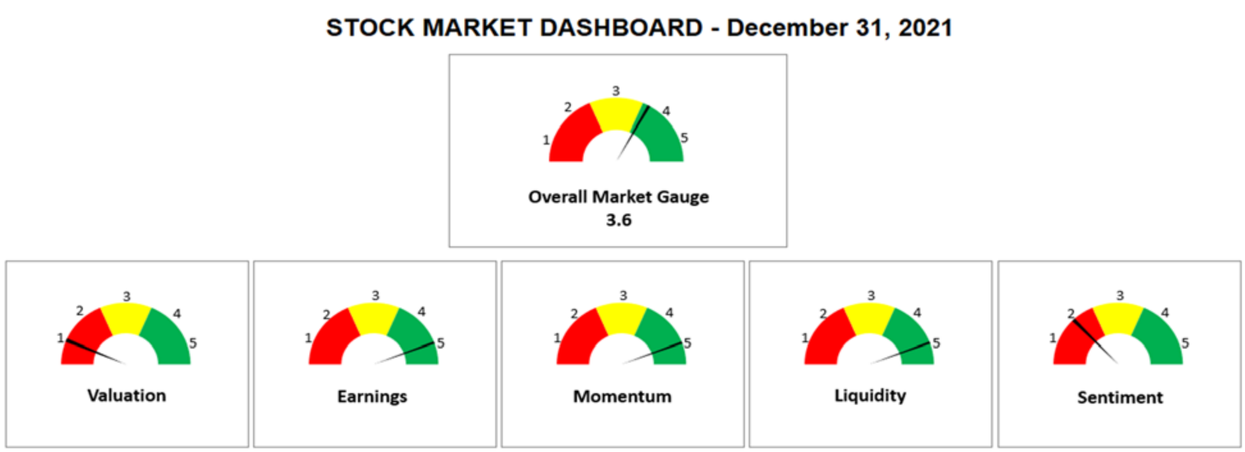
A recent survey of about 40 investment advisory firms indicated similar expectations for annualized returns of 5.8% over the next decade vs. the 150-year average of about 10.0%.

International Stocks Are At A Discount: International stocks, which historically trade at valuations similar to U.S. stocks, are now at a significant discount, with a 10-year P/E ratio of about 24, implying higher returns over the next decade. Combined with stronger expected earnings growth, international stocks look attractive.

10-Year P/E (US vs Europe)

Source: Barclays

Other Stock Market Indicators Are Strong: Valuation is just one measure we track when considering the attractiveness of the stock market, represented by our Stock Market Dashboard. Other metrics, such as earnings growth, liquidity, and momentum are currently showing very strong levels. As a result, our overall dashboard gauge has a positive reading, as shown below.

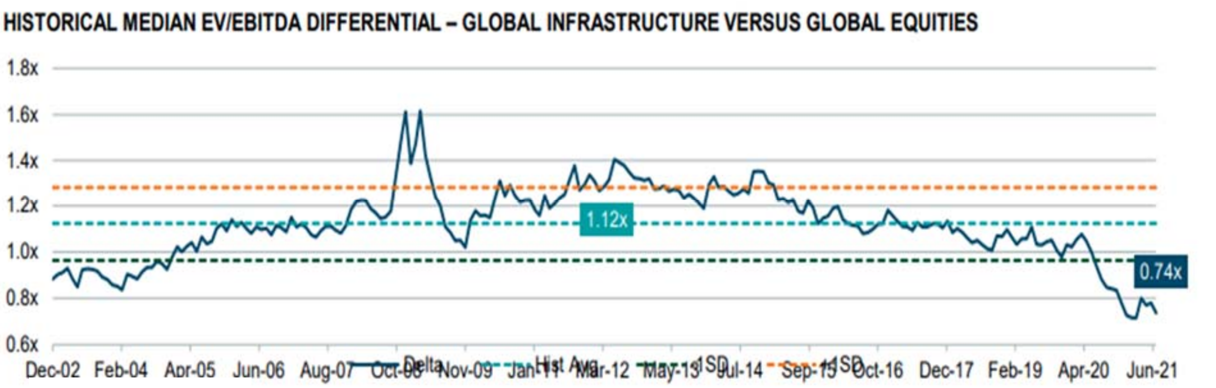


Source: Paragon Capital Management

Part of the strong liquidity measure in our dashboard is that interest rates remain very low, which has helped push stock valuations higher. A tightening of monetary policy and significantly rising rates could prove challenging for valuations.

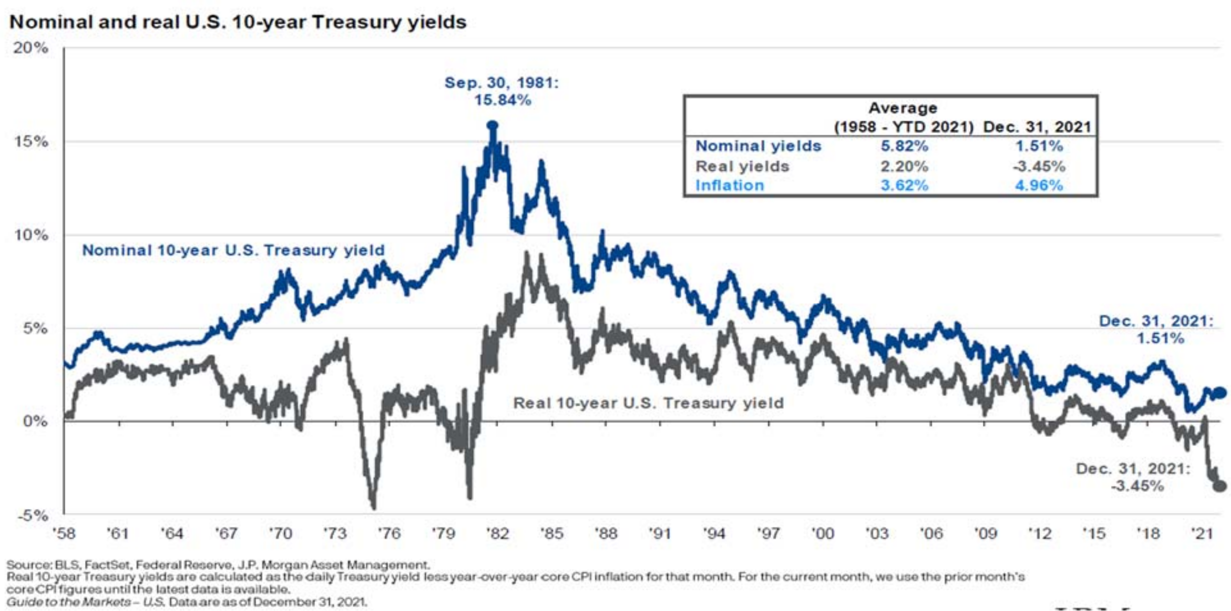
Another contributor to high valuations and potential continued strong returns are the numerous transformative innovations we're witnessing. These include electric/autonomous vehicles, healthcare/biotech innovations, robotics, artificial intelligence/machine learning, cryptocurrencies, and quantum computing.

For these reasons, we're staying invested in stocks, but leaning more toward less extreme valuation areas, such as international and small company stocks. We also recently bought a global infrastructure fund, which acts as an inflation hedge and is relatively cheap vs. the broader stock market. The strategy focuses on companies that manage regulated utilities, railroads, ports, toll roads, and cell phone towers which have contractual price escalators linked to inflation.



Source: DWS

<u>Bond Valuations Are Also Historically High</u>: Despite a recent uptick in yields, bonds are still trading near all-time low yields. 10-year Treasury bond yields appear to still be in a 40-year downtrend despite the recent increase in inflation. Given recent high inflation data, "real" yields (ie after inflation) are negative, and at the lowest levels since the mid-1970s.



The best indicator of future bond returns is the current yield, implying that 10-year Treasury returns should be about 1.45% annually. However, many other bond sectors, such as mortgages, corporate and municipal bonds have yields higher than 2%. We are maintaining our position in short-to-intermediate-term high-quality bonds, which should be less susceptible to rising rates if that eventually happens.