

Being Prudent Means Being Risk Aware Not Risk Averse

Reduced risk due to market conditions

"Why are you so defensively positioned?" was a question often asked to the Prudent portfolio management team in 2024.

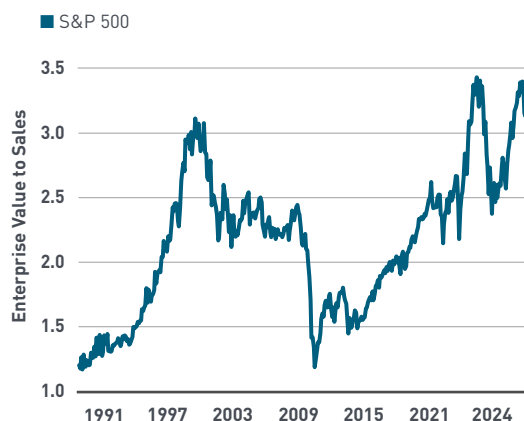
Our response throughout this period has been consistent: while we cannot know what future returns will look like for equity markets, we can look at history and ask ourselves a simple question: "When the market has been this expensive in the past, how attractive have returns been over the ensuing one, three and five year periods?"

Of course, there are different ways of measuring whether a stock market is expensive (Is the price-to-earnings ratio elevated? Are corporate profit margins cyclically inflated? Are equities cheap relative to lower risk instruments such as government bonds?), but at present – and for most of the last 18 months – the stock market has looked expensive by almost any metric.

One metric we particularly value is Enterprise Value to Sales, which compares the total debt and equity value of companies to their sales over the last twelve months. Unlike forward price-to-earnings ratios, this metric avoids projections or assumptions about future growth rates or margin levels. In our research of various financial metrics, we have found Enterprise Value to Sales to be one of the best predictors of future equity market returns (both positive and negative). Looking at history, since 1990 the S&P 500 has only been more expensive during two periods: the dot-com bubble (2000) and the post-COVID bubble (2021). By way of comparison, and because most financial commentators focus exclusively on the price-to-earnings ratio of the S&P 500, we have also included the chart below. While not as elevated as the Enterprise Value to Sales, the price-to-earnings ratio paints a similar picture: US equity markets have rarely been more expensive, and have typically only reached current valuation levels toward the end of a financial bubble.



S&P 500 Enterprise Value to Sales



S&P 500 Price to Earnings



Source: Bloomberg. LHS: Enterprise Value to Sales is last-twelve-months. Monthly data from 31 January 1991 to 30 May 2025. RHS: Trailing P/E = last-twelve-months. Monthly data from 31 January 1991 to 30 May 2025.

Given this backdrop, our view throughout much of 2024 was that the data did not support increasing exposure to risk assets. Equity markets were among the most expensive in history, even as U.S. interest rates remained at their highest levels since the 2009 financial crisis. With potentially attractive returns available through our fixed-income allocation, we were content to remain patient, defensively positioned, and wait for compelling opportunities on the equity side to emerge.

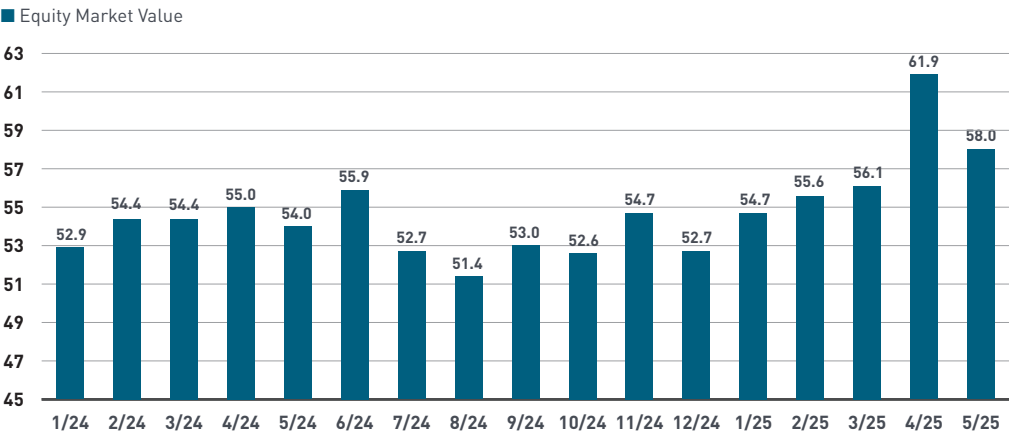
Increased uncertainty presents opportunity

Being prudent does not mean being risk-averse; it means being risk-aware. It also means remaining agile to add equity exposure when the risk/return profile improves. Increased uncertainty during April, driven by U.S. trade policy, led to heightened market volatility and greater price dispersion. For prudent investors this type of volatility creates opportunities, which is one of the key reasons we maintain defensive positioning with a significant weight in cash and short-term fixed income.

We are hyper-aware of the price we pay for securities, and the market downturn in April presented attractive risk/return opportunities in many companies we had been monitoring. Following the sell-off, we increased net equity exposure post-“Liberation Day”, adding to existing holdings and broadening our equity portfolio into sectors such as technology, semiconductor capital equipment, quality cyclicals, and even energy. However, with the rapid market rebound since mid April, we have since adopted a more cautious approach, trimming many positions that experienced strong rebounds during April and May.



Prudent Capital Fund Market Exposure Management



Source: MFS as at 31 May 2025.
Note: Market value exposure excludes cash & cash equivalents, bonds, and hedges. Equivalent exposure, measures how a portfolio's value would change due to price changes in an asset held either directly or, in the case of a derivative contract, indirectly.

Our ultimate goal is to grow client’s capital in real terms over time. To achieve this, we remain patient and disciplined, deploying capital when compelling opportunities arise. We continue to actively search for these opportunities and remain agile in our investment approach to capitalize on them when they emerge.

The future is hard to predict but quite possible, in our view, to prepare for — and the recent market turmoil illustrates the value of a prudent approach.

As long-term investors, we embrace the concept of looking ahead and continue to stay disciplined and diversified. One of the strategy’s goals is seeking to manage downside risk and we have an absolute return focus. When current prices are high and forward returns appear poor, the portfolio will be defensively positioned. However, the recent market volatility offered us opportunities, on an idiosyncratic basis, to find high quality, durable franchises trading at valuations we have not seen in a long time.

Our belief is that investing in companies with durable business models, underpinned by durable cash flows and managed for long-term success will generate attractive risk-adjusted returns for clients. ▲



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