

Three Portfolio Takeaways Inspired by Buffett

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Key Takeaways

- Buffett's growing cash reserves signal caution in an overvalued U.S. market, where the S&P 500's lofty multiples point to muted future returns.
- Japanese equities offer compelling valuations, higher earnings yields and additional returns from interest rate differentials.
- Small caps and value stocks may provide attractive entry points with potential tailwinds from tax policy changes and shareholder yield strategies.

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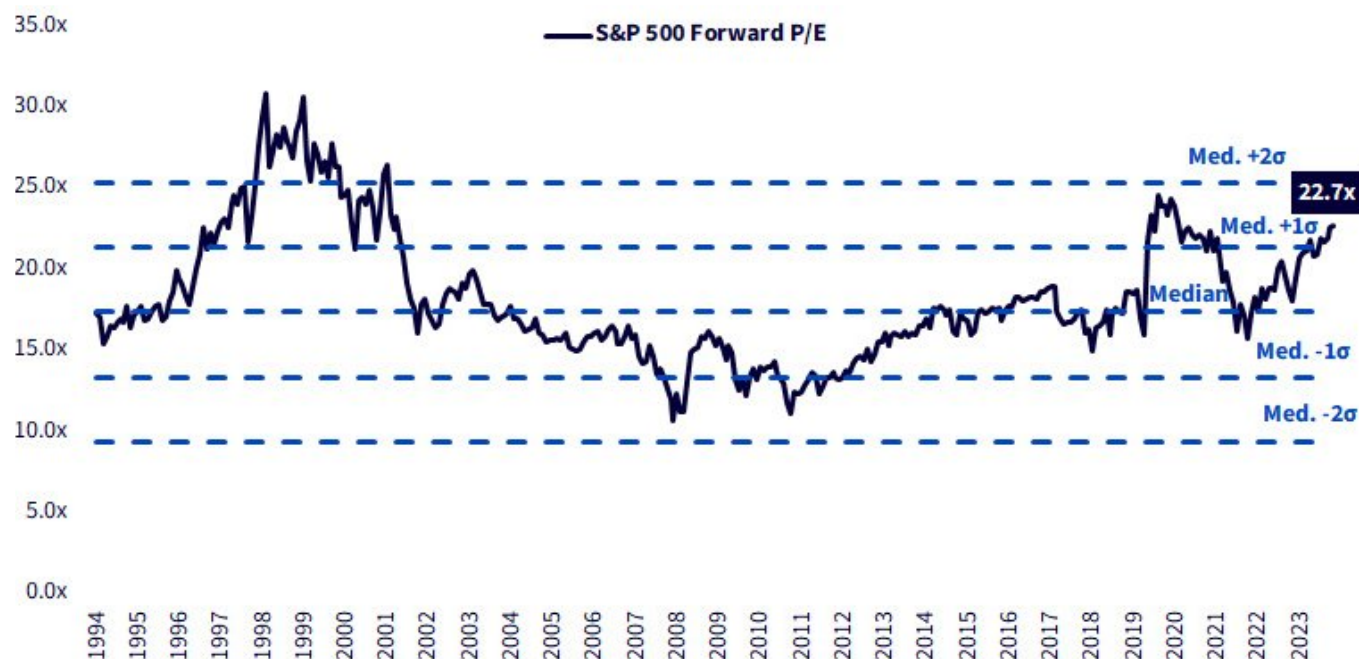
Warren Buffett's portfolio always receives special attention from the investing community.

Recently, the Oracle of Omaha has been raising cash, and he now has about \$325 billion on the sidelines. Berkshire may soon have even more dry powder at its disposal as well, as it continues trimming exposure to two of its largest holdings, Apple and Bank of America.

Berkshire's cash hoarding contradicts the sentiment of other investors at a time when the S&P 500 is routinely notching all-time highs and sporting near-30% year-to-date gains to conclude 2024. Buffett acolytes like us are forced to consider what is dampening his enthusiasm.

Perhaps Buffett is discouraged by future equity return prospects, given prevailing valuations. The S&P 500 trades at 23x future earnings, which is more than a full standard deviation above its 30-year median, as shown in figure 1. That corresponds to a 4.4% forward earnings yield, about 135 basis points (bps) below its median.

Figure 1: 2024's "Melt-up" Suggests Lackluster Future Returns

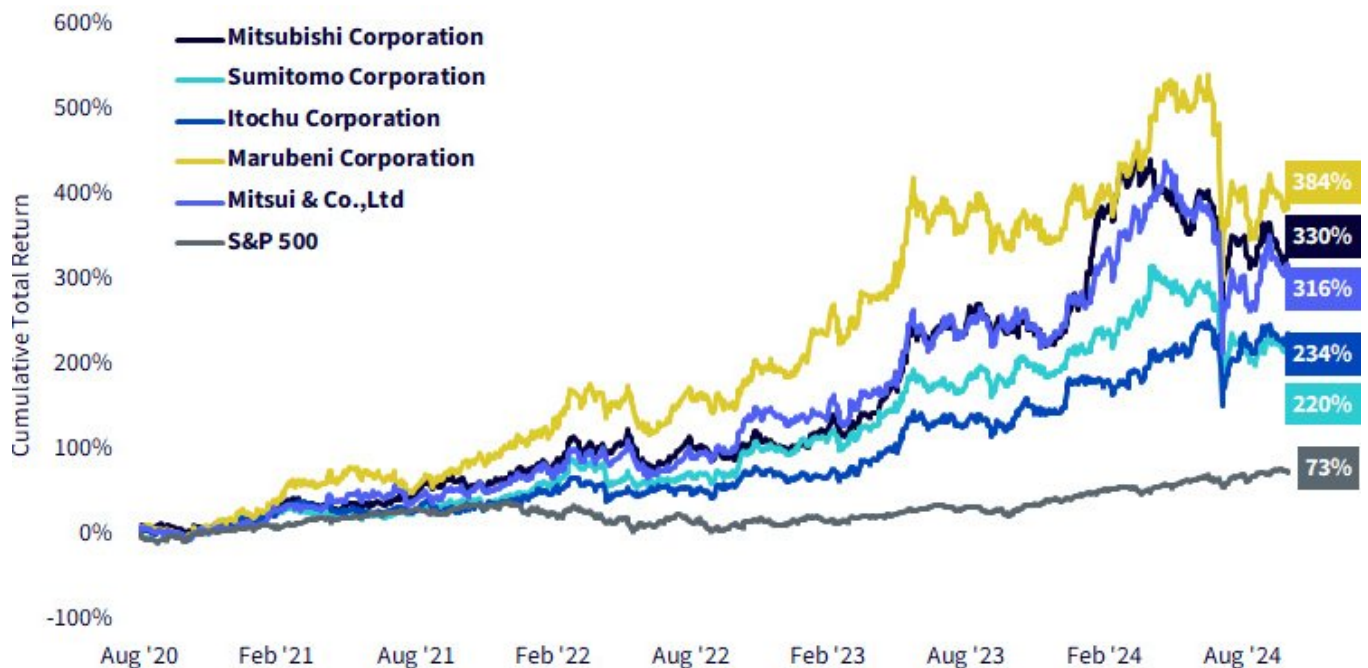


Sources: WisdomTree, FactSet, as of 10/31/24. You cannot invest directly in an index.

This valuation reality has prompted several strategists and esteemed managers to predict low-single-digit U.S. equity market returns over the next few years. David Kostin's team at Goldman Sachs recently made a call for just 3% annualized returns over the next decade.

The more subdued outlook is forcing U.S. investors to look overseas for opportunities with better return prospects and palatable valuations. Buffett and Berkshire are familiar here as well. His enthusiasm for Japanese equities has been evident since mid-2020, when he began buying a cohort of trading firms that have delivered lush returns and eclipsed the S&P 500, as demonstrated in figure 2.

Figure 2: Returns of Buffett's Japanese Investments since 2020



Source: WisdomTree, FactSet as of 10/31/2024. Past performance is not indicative of future results. You cannot invest directly in an index.

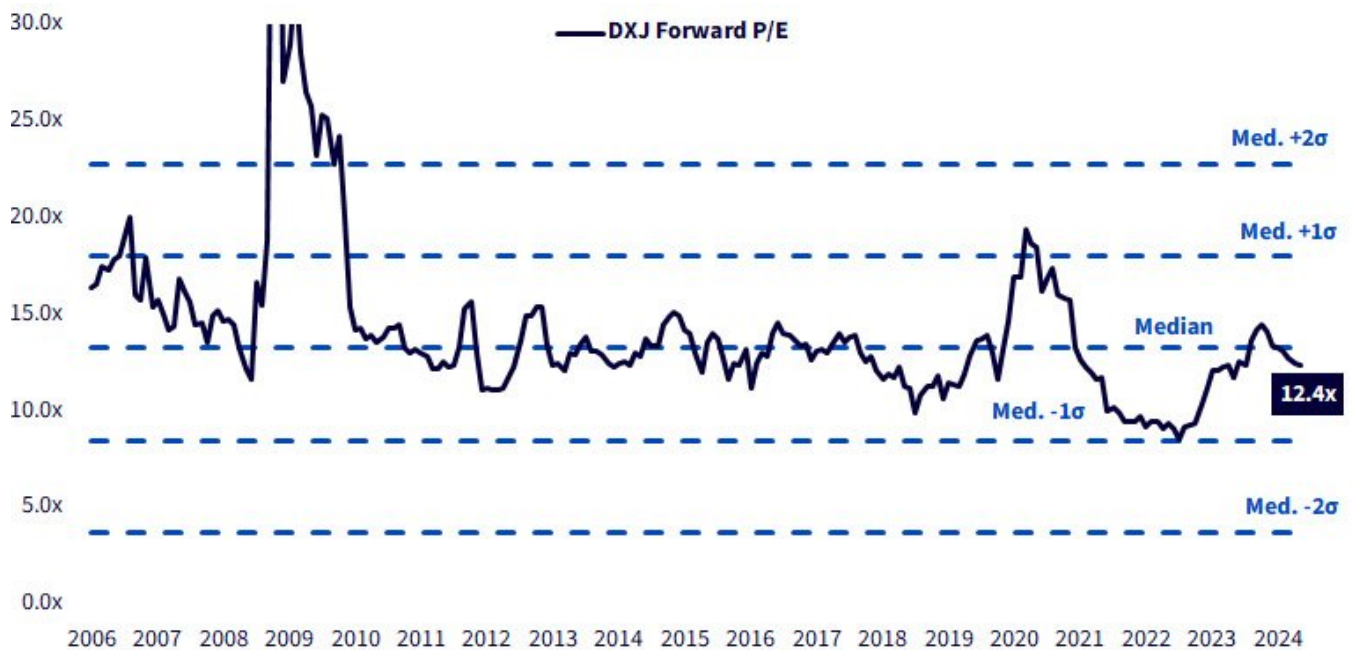
For fellow Buffett disciples, we have a few ideas that can keep you invested without piling more money into saturated areas of the market.

Low Multiples and Rates Make Japan an Opportunistic Outlier

From an international equity standpoint, we think our [Japan Hedged Equity Fund \(DXJ\)](#) is a prime candidate to proxy Buffett's enthusiasm for Japan.

As figure 3 shows, [DXJ](#) currently trades at 12x next year's earnings, which is slightly below its median since inception in 2006. This corresponds to an 8.1% earnings yield, which is about 60 bps higher than its historical median. It's also about 3.7% higher than that currently offered by the S&P 500, providing an attractive entry point for potential allocators.

Figure 3: DXJ Seeks to Offer Attractive Valuations despite Strong Gains YTD



Sources: WisdomTree, FactSet, as of 10/31/24. You cannot invest directly in an index.

Meanwhile, the yield on 10-year Japanese government bonds is only about 1%, providing more than a 7% cushion between that and the region's earnings yield. On the other hand, 10-Year U.S. Treasuries yield about 4.4% right now, which matches the forward earnings yield for the S&P 500 given its lofty multiple, thereby eliminating any risk premium.

But there's more similarity between **DXJ** and Buffett's interest in Japan than simply owning Japanese stocks outright. **DXJ's** approach to currency is perfectly aligned with how Berkshire chose to buy Japanese stocks.

DXJ's static currency hedge eliminates the risk of adverse yen-dollar fluctuations eroding returns from the equity basket. Hedging currency exposure has been a favorite tactic of Buffett's since he entered his Japanese investment during the pandemic. He issued yen-denominated bonds to offset the inherent long yen exposure from the equities so that the return from his investment was isolated to the performance of the stocks themselves.

That certainly helps from a risk reduction standpoint, but it's even more additive today when yen-hedged investors can obtain incremental return via the carry opportunity provided by hedging. Based on prevailing interest rate differentials between the U.S. and Japan, hedging yen exposure can deliver an extra 4.7% of annualized return, which can be seen in figure 4. This will likely fall as the Fed cuts rates but may average as much as 3% over the coming years. This provides incremental returns on top of what local Japanese investors can earn domestically.

Figure 4: Annualized Carry by Currency



Sources: WisdomTree, MSCI. Carry measures the interest rate differential between the U.S. dollar and foreign currencies embedded in the difference in spot and forward FX rates. Carry by currency beginning on 12/31/14. MSCI EAFE Index carry beginning on 12/31/15. You cannot invest directly in an index.

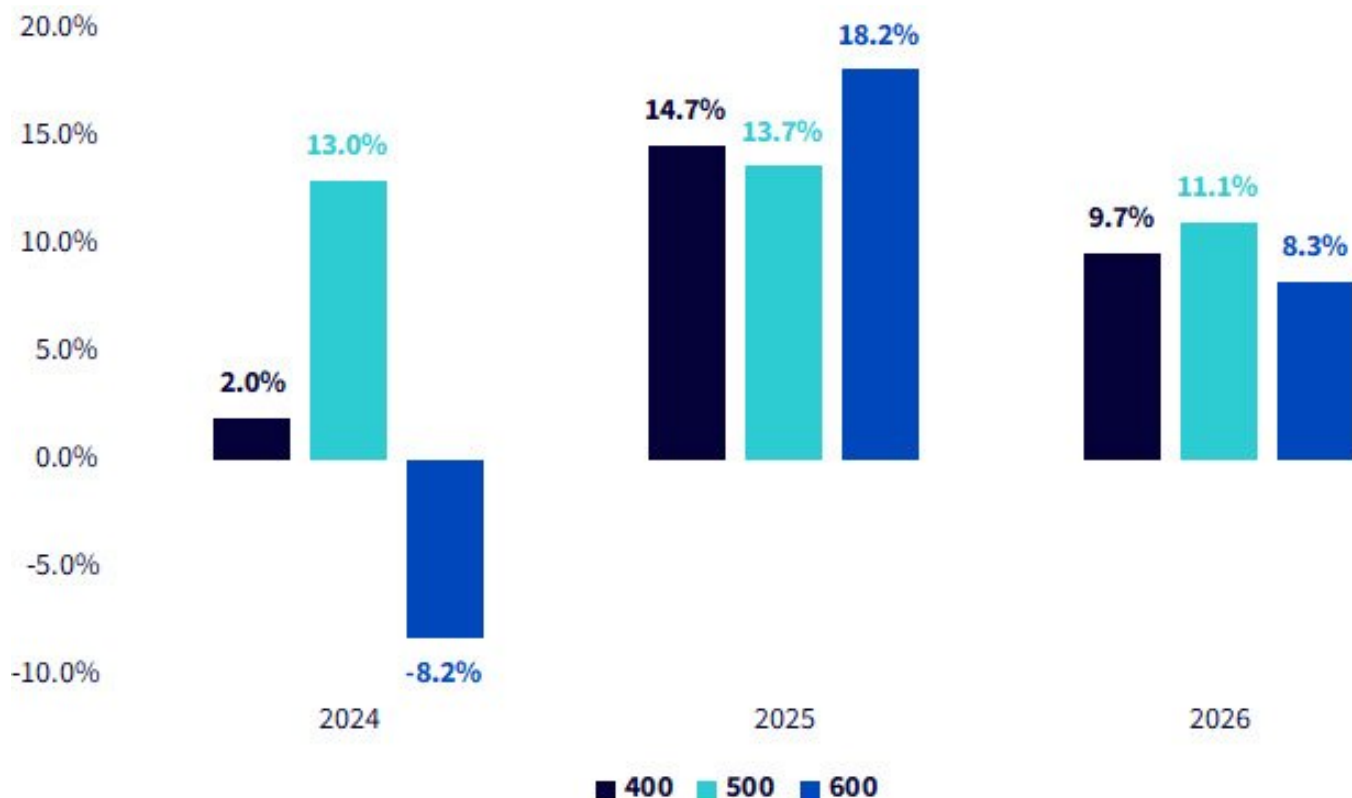
Small Cap Earnings May Surprise to the Upside

Though the consensus is for low U.S. equity returns over the next few years, we think there are still pockets of the market that may be compelling for investors who want to maintain domestic allocations without defaulting to the S&P 500 experience. Small caps are one opportunity.

Excluding currently unprofitable companies, the Russell 2000 Index trades at 16x next year's earnings, which is just below its 20-year median.

Earnings projections for 2025 are expected to recover as well. Looking at the S&P family of large, mid- and small caps in figure 5, the [S&P SmallCap 600](#) is forecasted for greater earnings growth than the larger segments for 2025.

Figure 5: Forward Operating Earnings



Source: WisdomTree Earnings PATH, as of 11/11/2024. You cannot invest directly in an index. 400=S&P MidCap 400, 500=S&P 500, and 600=S&P SmallCap 600.

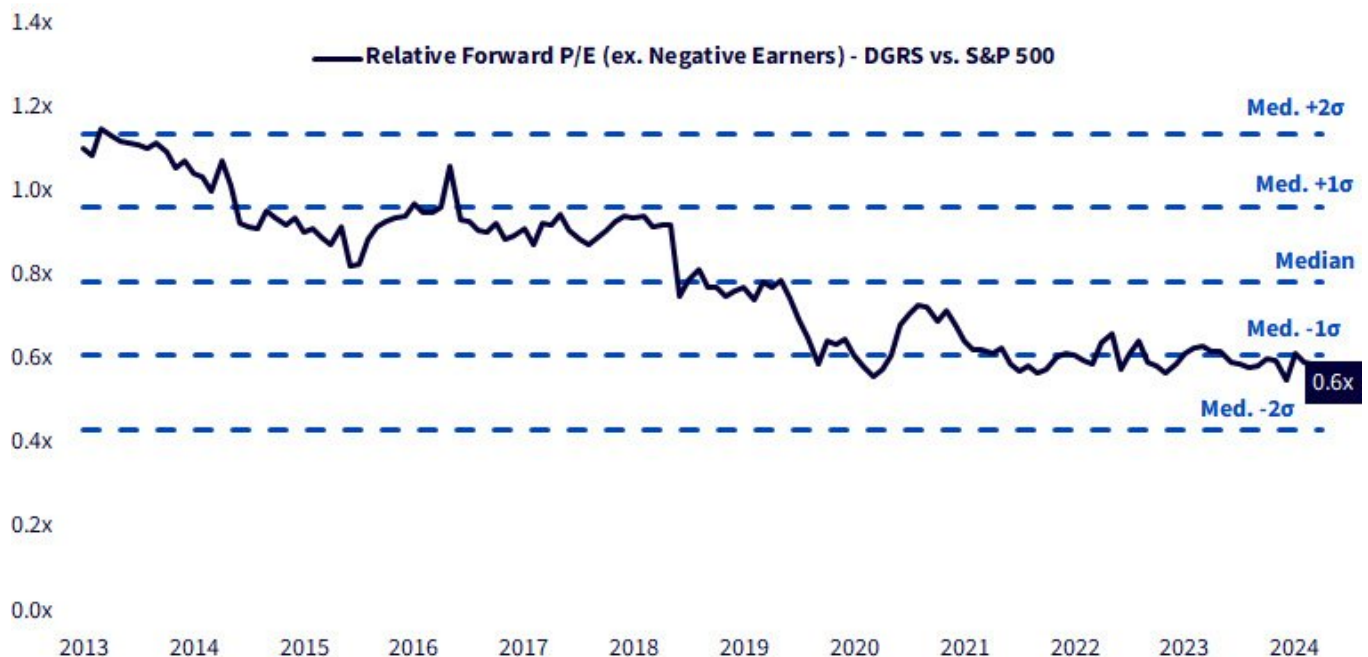
But the earnings picture may improve further if the incoming Trump administration can successfully enact a corporate tax rate cut, given the business-friendly and pro-growth Republican Congress. [Small caps, in particular, stand to benefit the most](#) from any decrease in the corporate tax rate, as their operations and revenue sources are more heavily concentrated in the U.S. than their larger peers. Slashing their tax rate would give a meaningful boost to their bottom lines, as they would retain a greater proportion of every marginal dollar earned in the U.S.

A tax policy tailwind would be a potential boon to our small-cap outlook, and one that could make the future return environment for U.S. equities more compelling for discerning investors.

Looking toward the future, the [WisdomTree U.S. SmallCap Quality Dividend Growth Fund \(DGRS\)](#) is our preferred avenue for small caps, no matter what environment lies ahead.

It offers compelling valuations as well. Figure 6 shows us that since inception in 2013, [DGRS's](#) forward price-to-earnings (P/E) has steadily fallen versus the S&P 500 and remains about one standard deviation below its long-term median today.

Figure 6: Small-Cap Neglect Presents a Valuation Opportunity against Lofty Large-Cap Multiples



Sources: WisdomTree, FactSet, as of 10/31/24. You cannot invest directly in an index.

The “neglect” of small caps over the last few years, while large caps had the wind at their sails, presents a valuation opportunity today. Small caps may offer attractive valuations at exactly the time that investors are willing to give them a second look.

Rethinking Value with a Buyback Focus

If nothing else, Buffett may be most famous for his value discipline. Identifying underpriced, undervalued businesses has been the hallmark of his 70-year investing career.

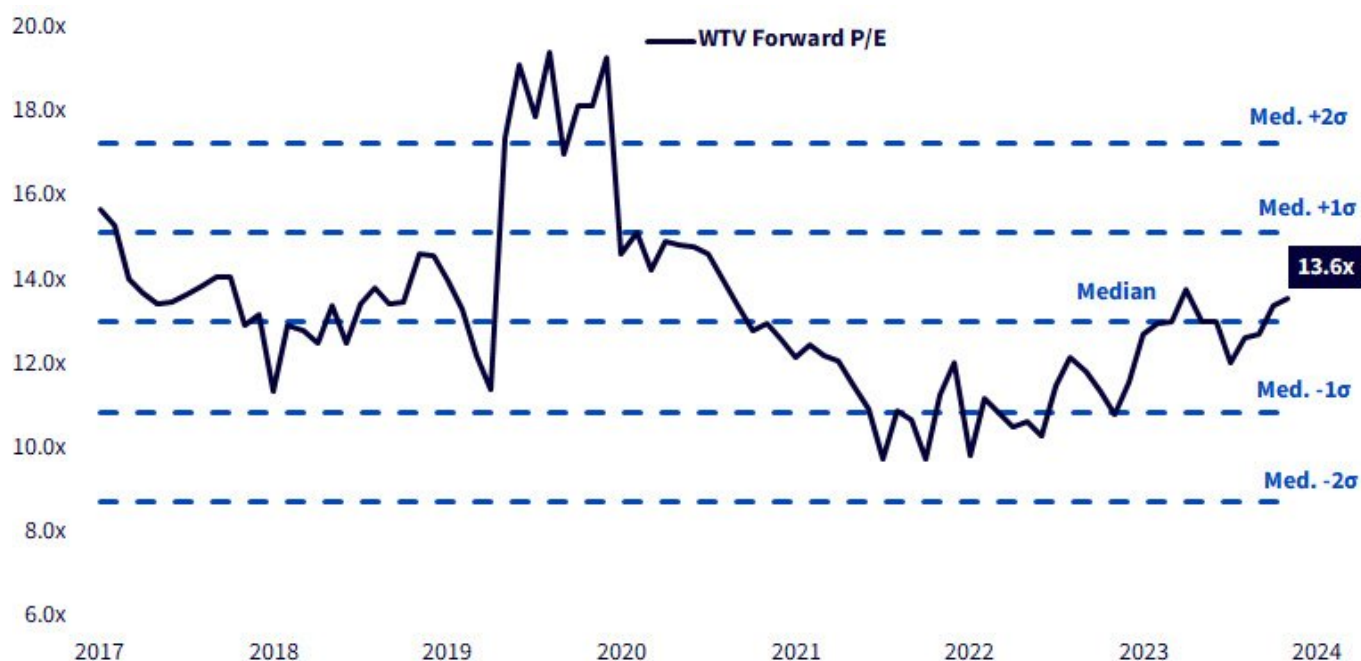
But over time, value has evolved to comprise several different flavors, and one of the most popular avenues to access value over the past decade is one that Buffett is practicing in his leadership of Berkshire Hathaway: stock buybacks.

Buybacks have become a mutually beneficial mechanism for delivering value for corporations and shareholders alike. They allow businesses to improve their financials and provide value to stockholders while simultaneously avoiding costly dividend payments.

We unite these two Buffett pillars in the [WisdomTree U.S. Value Fund \(WTV\)](#), an actively managed Fund that pursues a value strategy through a shareholder yield lens. Shareholder yield represents the marriage of dividend yield, a bedrock of value investing, and share buybacks.

[WTV](#) currently trades at less than 14x forward earnings, shown in figure 7, which is only about a half-point above its median since inception. That corresponds to a 7.4% earnings yield, more than 3% higher than that of the S&P 500.

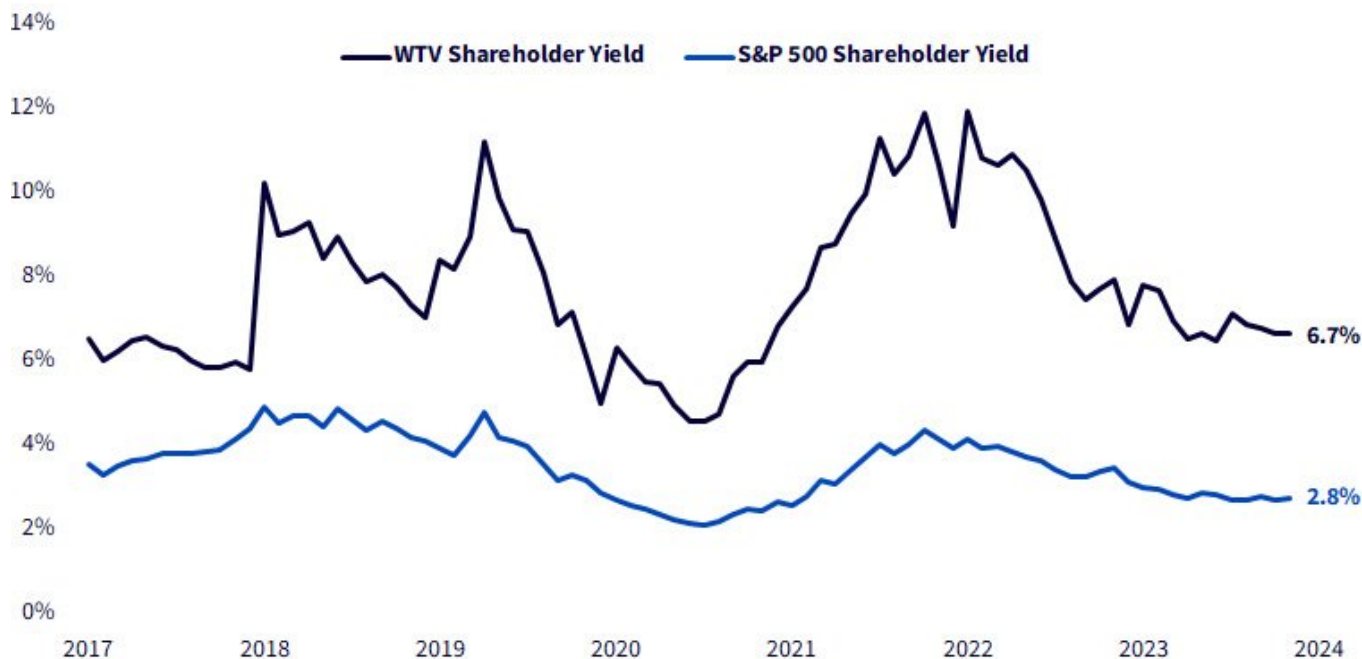
Figure 7: Value Strategies Tend to Have Lower Multiples



Sources: WisdomTree, FactSet, as of 10/31/24. You cannot invest directly in an index.

When you measure the equity basket's shareholder yield and combine it with the projected earnings yield, [WTV](#) offers about double that of the S&P 500 as well, as we see in figure 8.

Figure 8: Shareholder Yield-Focused Framework May Make Equities Compelling When Markets Have Less Yield to Offer



Source: WisdomTree, FactSet, as of 10/31/24. You cannot invest directly in an index.

Three High-Conviction Ideas for 2025

Heading into 2025, we believe that market opportunities still exist despite calls for lower future U.S. returns amid lofty valuations. Now more than ever, however, we believe investors should be discerning of equity regions, asset classes and fundamentals to potentially maximize the benefit of their allocations. They may find themselves simultaneously avoiding lackluster returns within U.S. large caps, if forecasts from today's strategists prove accurate, and any volatility along the way, compounding the benefit.

Three of our high-conviction ideas for next year closely align with Buffett's survey of the equity market landscape and his lifelong approach to investing. Given his track record, we're encouraged.

For other Buffett enthusiasts, it may now be worthwhile to revisit Japan, value and small-cap allocations within portfolios.

Important Risks Related to this Article

For current holdings, please click the respective ticker: [DXJ](#), [WTV](#), [DGRS](#). Holdings are subject to risk and change.

There are risks associated with investing, including the possible loss of principal. Please read the Fund's prospectus for specific details regarding the Fund's risk profile.

DXJ: Foreign investing involves special risks, such as risk of loss from currency fluctuation or political or economic uncertainty. The Fund focuses its investments in Japan, thereby increasing the impact of events and developments in Japan that can adversely affect performance. Investments in currency involve additional special risks, such as credit risk and interest rate fluctuations. Derivative investments can be volatile and may be less liquid than other securities and more sensitive to the effect of varied economic conditions. As this Fund can have a high concentration in some issuers, the Fund can be adversely impacted by changes affecting those issuers. Due to the investment strategy of this Fund, it may make higher capital gain distributions than other ETFs. Dividends are not guaranteed, and a company currently paying dividends may cease paying dividends at any time.

WTV: Funds focusing their investments on certain sectors increase their vulnerability to any single economic or regulatory development. This may result in greater share price volatility. While the Fund is actively managed, the Fund's investment process is expected to be heavily dependent on quantitative models, and the models may not perform as intended.

DGRS: Funds focusing their investments on certain sectors and/or smaller companies increase their vulnerability to any single economic or regulatory development. This may result in greater share price volatility. Dividends are not guaranteed, and a company currently paying dividends may cease paying dividends at any time.