Welcome to Money For the Rest of Us Plus. This is the premium podcast episode for Plus members, episode 305. I'm recording this Thursday afternoon, July 16th. In today's episode, we have a mid-month update. We will discuss the inclusion effect for index funds as Tesla potentially is added to the S&P 500 index after it's gained 500% year-to-date.

We have a question regarding earnings surprises and the ability of analysts to beat estimates with regards to quarterly earnings, and whether they're getting better at that or worse. And finally, a question on the Cadence private lending platform.

Through today, July 16th, the All Country World Index Global Stocks have gained 4.2% for the month, and they're now down only 2.3% year-to-date, led by Europe, which has gained over 5% for the month. Emerging markets were also a big contributor, they've gained over 5.5% for the month, and are down 4.8% year-to-date. So the stock market advance continues, but the level of uncertainty with regard to the pandemic spread, particularly in the U.S, is increasing.

Economic releases that we've seen—U.S. retail sales were released today for the month of June. They showed a 7.5% month-over-month gain. It was well above the consensus expectation of 5%. Sales were down overall 21.8% from where they were pre-pandemic, with the bottom in April, and now they're only about 1% below the pre-pandemic level.

We've seen similar types of sales rebound in other countries around the world, but with some of the real-time data in July.

Consumers are holding back from visiting stores, restaurants, and malls like they were, some of the footfall measures, and as a result we're not sure to what extent the U.S. economy will be impacted as partial lockdowns are reinstated.

The government-sponsored support schemes for unemployment benefits and other stimulus-type checks are starting to expire throughout the world, yet the unemployment rate remains high. So the economic recovery is going to be gradual and slow and patchy, like we discussed in the investment conditions report. And that's why the models are still conservatively-positioned as we wait and see what happens over these next few critical weeks.

There was an article a few days ago in the Wall Street Journal by Spencer Jakab, and he was discussing—although he didn't really use this term—of the inclusion effect. He pointed out "When Berkshire Hathaway split their stock in 2010 and became eligible for the S&P 500, it beat the index by over 15%, but it has lagged since then." He expressed the concern that if Tesla is able to generate a quarterly profit for the second quarter, it would be eligible for inclusion in the S&P 500 index. I mentioned it's already increased 500%. It would be well over 1% of the index, and he was speculating what the potential return will be if Tesla ends up disappointing.

One of the things that has driven Tesla's rise this year is the ability for individual investors to buy fractional shares. Some stocks—Apple is price over $300, Netflix $500, Alphabet $1,500, Amazon $3,000. If you're an individual investor just starting out, that's a lot of money for one stock.

Robin Hood popularized the ability to buy fractional shares, but this spring Fidelity and Charles Schwab have allowed that. Charles Schwab reported today that they had 1.65 million new retail

brokerage accounts added, four times the amount from a year ago (386k). And trading activity increased 126% from a year ago. So more people are buying stocks, specifically fractional shares.

Even though Jakab is worried about the impact of Tesla the inclusion effect actually shows that when stocks are added to the S&P 500, that they actually do better than the overall market. And their speculation—well, why is that? One of the leading reasons was more people have to buy it now that it's part of the index, and so that's pushing up the price.

I'll link to a paper on inclusion effects by three co-authors—Chang, Hong, and Liskovich. They don't think that's the case. They believe that the reason why stocks do better once they're added to the S&P 500 is name recognition. People become aware of the stock, and that's one reason when a stock leaves some of these indices, it doesn't necessarily fall in price, because that name recognition continues. This inclusion effect has been around and recognized for many years.

When it comes to indexing, we have to decide how we're going to index. This member's question was "Is the situation with Tesla an unavoidable hazard of indexing, and what's the answer?" Well, to be honest, I already thought Tesla was in the S&P 500, and there's some people that surmise one reason Tesla is doing well is that people think it's going to be added to the S&P 500 and that will further push up the price.

The reason why Tesla is not in the S&P 500 is one of the criteria—it has to generate a quarterly profit for the previous four quarters. Tesla has done so over the previous three, that's why the second quarter is key.

But when we index, we have to look at what is the criteria and what is the methodology. Tesla is already a part of broader indices, that are purely capitalization-weighted, based on price. They don't exclude companies with negative earnings. For example, Tesla has a 0.76% weight in the Russel 1000 stock index. It has a 0.3% weight in the Vanguard Total World Stock Market ETF (VT). It has a 0.5% weight in the Vanguard Total Stock Market ETF (VTI).

The broader indices have included it, it's just that some indices are much more narrow. The Dow Jones Industrial Average is even more narrow. So when we think about something like Tesla, we have to consider—well, how is the index constructed? How broad is it? How many stocks are there?

We also have to consider "Is it a market capitalization-weighted index?", market capitalization being the price of the stock times the number of shares outstanding. Market capitalization-weighted indices are the most efficient because you don't have to rebalance because the weight in the index is the price times the number of shares.

The downside to a capitalization-weighted index is something like Amazon. Amazon makes up 5% of the S&P 500 index. Its price-to-sales ratio right now is five times. That's the highest going back to 2001. The price-to-sales ratio of the overall S&P 500 index is 2.1. So as a stock becomes more and more expensive on a price-to-earnings ratio basis or on a price-to-sales basis, it becomes a bigger part of the index. One of the ways around that is to use a fundamentally-weighted index, that isn't weighted by price. Or even an equal-weighted index.

In the model portfolios, we have the Schwab Fundamental U.S. Broad Market ETF. The benefit of a fundamentally-weighted index is if a stock gets more expensive and it becomes overpriced, overvalued relative to its intrinsic value, it becomes a bigger weight of the index. And if a stock is

undervalued, it's a smaller weight of the index. A fundamentally-weighted index would be selling the overvalued stocks and buying the undervalued stocks as part of its rebalancing mechanism because it's weighting based on something besides price; it's doing it based on revenue, or earnings.

That Schwab Fundamental U.S. broad market ETF has 0.3% in Tesla, and 0.57% in Amazon, versus 5% for the S&P 500. Over time, that should lead to outperformance. It hasn't done so in the last five years. The S&P 500 has returned 11%. The U.S. Broad Market Fundamental Index ETF has returned 6.9%, so much less. But much of that outperformance has been these big caps stocks getting more expensive.

The price-to-sales ratio of FNDB, the Schwab Fundamental U.S. Broad Market ETF is 0.85%. Its long-term earnings growth has been 7.9%. The S&P 500 has a price-to-sales twice as much, 2.15%. Its long-term earnings growth is 8.9%, so just a little bit higher, yet the valuation is twice as high. On a P/E basis, the S&P 500 is 23.4, FNDB is 17.7—that's all data from Morning Star. It probably excludes companies with negative earnings.

There's a new post on the member forums regarding that under the asset allocation section, specifically as it relates to small-cap stocks. But it's been a challenging period to index in a fundamental way, away from a market capitalization index, because that manner of indexing is more value-oriented, and value certainly has underperformed. But the bottom line is if you own a broader-market index fund, you already have exposure to Tesla. It's just those that index using the S&P 500 that don't.

I have a question from another member—he asked about how an analyst predicts earnings-per-share for a publicly-traded company, and why are so many analysts missing estimates? And is the trend of beating or missing estimates going up, or down in the past years/decades, given that information is more transparent?

Analysts build earnings models and they talk to company management. And actually, I hadn't looked at this in a long time. So back in the '90s and early 2000s there was something called "whisper estimates", where a stock manager could get information from company management that wasn't necessarily available to everyone. If they just dug deeper, they could come up with pretty solid earnings estimates. But then in 2002 when the Sarbanes–Oxley Act was passed in the U.S, companies were required to make sure that all information related to the stock or the company needed to be made available to everyone, at the same time. And what's interesting about that is positive earnings surprises prior to 2002 were much lower. I eyeballed it and it looked to be at an average of around 60%, whereas over the past 26 years the average has been 72% of companies beat earnings.

Companies are exceeding earnings estimates more than they ever have. I think there's two reasons for that. One, this Sarbanes–Oxley—it's more difficult for an analyst to get some type of informational edge to figure out whether a company is going to beat estimates or not. But I also think companies, because they have more control of the information, that they try to make sure and guide analysts so that they can beat the estimates because stocks that don't are punished more and drop significantly. So that's always been kind of a game. Legislation impacts that, but the bottom line is companies are surprising to the upside more than they ever have, so they're not punished. And because they have better control of the information.

Finally, I had a question about a new private credit platform called Cadence. I had not heard of this. This is similar to a Yieldstreet or some of these other platforms out there. I've discussed the risk with these platforms both in episode 301 on alternative investments, but I also talked about lending on the fringes of finance in episode 304. Cadence is for accredited investors, so you have to meet certain net worth and income thresholds.

As far as I could tell, they started this private lending aspect back in 2019. I think prior to that they were much more involved in the cryptocurrency space. They say they've done 88 deals, with over 94 million dollars in principal return. That the average yield has been 10.98%, and the delinquency rate is 0.01%.

I looked at some of the deals on there, and they tend to be very short-term, often backed by receivables. There's a short-term power sports vehicle financing, where you have exposure to a portfolio of powersports vehicle loans; it's a three-month term and 11.5% expected return.

There's a short-term mobile app financing, and there's also a short-term crypto-asset collateralized lending deal. These are complicated. You have to do your due diligence. I didn't spend time analyzing the deals. I was more interested in the structure.

Do you have collateral in the actual receivables, and have some type of security in whatever is backing those receivables, or is it some type of borrower payment-dependent note? And it is. It's a payment-dependent note. It is put in a special-purpose vehicle, and at least they acknowledge—there was a blog post that I'll link to, that they acknowledge the counterparty risk of these types of deals.

The purpose of an SPV is to separate it out in case the parent goes bankrupt, and there's some protection. It has an independent status. I am not an attorney. I've found one paper—it's 50 pages long—that I'll link to, that went through this and talked about there have been situations where courts have pierced through the SPV structure.

One of the important criteria is that the SPV be separate—has separate offices, separate records, separate financial statements. The Cadence blog post talked about these SPVs, if Cadence would go bankrupt, that the SPV would be overseen by a third-party, and they could continue to process payments. This seems to be a better structure than some of the original payment-dependent note structures, but we have to be cautious because these are complicated transactions.

Now, the good news is the terms are short, but it's also, given the pandemic, a very challenging time to lend. I've not done much due diligence on that to see if we can get financials of these companies, or get a better sense. Or are we trusting Cadence to do that due diligence or their partners?

I'm just making you aware of another platform. A member asked me to take a look at it; I was more concerned about the structure. I think using the SPVs is positive, but it depends on how they've structured the SPV in terms of how separate is it from the parent. And again, we have no information at all in terms of the financial standing of Cadence itself, the startup, VC-funded. There's always a risk the platform will shut down as we've seen with other crowdfunding platforms.

That then is Plus episode 305.