THE PRUDENT SPECULATOR

Where to Invest in 2021

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As the noted physicist Niels Bohr said, "Prediction is difficult, especially if it is about the future," so we long have been of the mind that time in the market trumps market timing. After all, equities have enjoyed average annualized returns of 9.6% (Growth Stocks) to 12.8% (Value Stocks) dating back to 1927, overcoming scores of disconcerting events in the process.

Keeping the faith that equities will prove rewarding in the fullness of time is easier said than done, with 2020 providing vivid illustration of just how difficult it can be for folks to focus on the long-term prospects of the companies in which they are invested. After all, the year began with reports of a deadly and highly contagious coronavirus emanating from Wuhan, China, and is ending with record daily U.S. COVID-19 cases, hospitalizations and fatalities. Sadly, as of mid-December, Johns Hopkins had calculated that more than 1.5 million lives had been lost around the world to the virus with the American death toll near 300,000.

As if worries about health were not enough, investors had to contend with a virtual ban on most travel, the shutdown of many businesses and inconsistent orders to stay and work from home from elected officials. Not surprisingly, the worst economic downturn since the Great Depression occurred in the spring, while the summer brought unprecedented social unrest and the fall a nasty presidential election campaign, whereby the media didn't declare an Oval Office winner until four days after the polls closed and the current Commander in Chief did not concede, meanwhile the balance of power in Congress rests on run-off elections for the two Georgia Senate seats. Throw in the deaths of basketball icon Kobe Bryant and soccer superstar Diego Maradona and 2020 will be remembered globally as one of the worst years ever.

Of course, while 2020 was as traumatic as any year in recent memory, with 2008 and 2001 arguably close competitors, the stock markets proved remarkably resilient. In fact, though there was a frightening five-week Bear Market from February 19 to March 23, in which the average stock lost over 40%, equities rebounded rapidly and dramatically, so much so that the year was on pace for fantastic returns for Growth stocks, many of which have actually seen their businesses benefit mightily due to the pandemic, and modestly positive gains for the majority of stocks, including those of inexpensively valued companies. And, if one judges the year simply by the performance of the S&P 500, 2020 appears likely to go down as well above average!

Alas, if we look throughout the year at sentiment numbers and flows out of domestic equity mutual and exchange traded funds, as well as all of the dollars that poured into bonds, government debt and money markets, we suspect that many an asset allocation was, and likely still is, light U.S. stocks. We think all of that money resting on the sidelines or parked in the supposed safety of fixed income bodes well for stocks in the new year, especially with news of surprisingly strong efficacy for COVID-19 vaccines from Pfizer/BioNTech and Moderna and the likelihood for a healthier global economy as the pandemic recedes.

So, while we are always braced for downside volatility as stocks historically have endured 5% downturns more than three times a year on average and 10% corrections more than once per year on average, we are optimistic in our outlook for equities in 2021. We remain partial to companies trading for inexpensive fundamental valuation metrics and that pay generous dividends, especially as the gap between Value and Growth is as wide as it has ever been, including at the peak of the Tech Bubble in the year 2000, and the low interest rate environment should favor income producing stocks, with yields on our portfolios well above 2%.

DON'T BOX US IN: ACTIVELY FINDING VALUE

While equity indexes generally focus on one or a couple valuation measures (e.g. price to book value) to segregate the market into Value and Growth divisions, we have long been equal opportunity stock pickers, focusing not just on backward-looking income statement and balance sheet calculations. Yes, we think these are important, and we will not consider a stock for purchase unless it ranks highly in our proprietary scoring system, but the markets are littered with the bones of stocks that had at one point traded for a single-digit P/E ratio or at a big discount to book value, only to see profits evaporate and assets written down to next to nothing.

Yes, we cannot always avoid the so-called Value traps, but we have long added qualitative reviews of our companies to the mix to ensure a viable business model, healthy competitive position, able management and, in the case of many cyclical companies, the wherewithal to make it through to the next upswing. Further, and perhaps most importantly, our Target Prices incorporate our view of each company's long-term growth prospects, so that the stocks we choose to buy offer significant total return potential (capital appreciation and income) relative to the risk we think is inherent in our ownership.

The Prudent Speculator is heading into its 44th year and we are always working to evolve our methodologies, but we think our unique and disciplined approach to navigating the equity markets will continue to serve us well as we believe that there is plenty of Value available in individual stock picking. That in mind, we detail in no particular order seven themes and specific stocks which we think those who share our long-term view should be considering as we head into 2021.

A SHOT IN THE ARM

After nine months of social distancing, limited travel and lockdowns inside of our homes, the rollout of multiple effective COVID-19 vaccines will set the stage for a return to normalcy as we move through 2021, with the economic outlook likely to be much more favorable in the new year. As a result, economically sensitive stocks are poised to turn in much better results and we believe that investors will likely reward many of 2020's laggard for posting very favorable earnings comparisons.

We can't ignore the staggering effort by the federal government in concert with Jay Powell & Co. at the Federal Reserve to back-stop the economy earlier in the year, which drove a record $2 trillion bump within U.S. deposit accounts over the first six months of 2020. Much of this increase found its way onto the balance sheets of the nation's largest banks like **JPMorgan Chase (JPM)**, **Bank of America (BAC)** and **Citigroup (C)**. Now sitting flush with reserves against losses, which bolsters earnings power going forward, bank stocks offer strong upside potential, we think their caution in extending credit in 2020 will reverse, allowing consumers to up their discretionary spending as they gain access to more liquidity.

And, with pent-up demand and a better jobs picture bolstering the consumer, beaten-down travel and leisure stocks like cruise operator **Royal Caribbean (RCL)**, aviation support firm **World Fuel Services (INT)** and air carrier **Delta Air Lines (DAL)** stand to benefit, as should battered retailers with staying power like **Kohl's (KSS)**, **Tapestry (TPR)** and **Foot Locker (FL).**

HOME: WORK, STAY, IMPROVE

Pandemic-related shutdowns around the world caused significant changes in the way people work. Businesses, many leery of policies that allow folks to work outside of the office for fear that they will be less productive, were forced to adapt on a time frame of weeks or months instead of years or decades. Zoom Video Communications is one of the more famous benefactors of the pandemic thanks to record demand for its video conference software. **Microsoft's (MSFT)** Teams platform, a Zoom competitor, also saw record adoption rates (including at Kovitz), while **Cisco Systems (CSCO)**, **Intel (INTC)** and **NetApp (NTAP)** produce hardware and software needed to make enterprise collaborative cloud environments tick.

Tech wasn't the only sector to benefit from a Work-From-Home ("WFH") economy. Big box retailer **Target (TGT)** saw record

online shopping numbers and benefitted handsomely from several years of work reshaping the business, including an ability to ship from a local store and easy-access small-format stores. **FedEx (FDX)** delivered many of those online packages, with shipping boxes made by **International Paper (IP)**. More time at home meant more focus on the need for upgrades. Home improvement center **Lowe's (LOW)** and home builder **MDC Holdings (MDC)** reported huge increases in revenue, especially as low interest rates made it easy to cheaply take on debt to finance home improvements or relocation.

Another refinancing boom swept the country early in the pandemic, as a surprise interest rate chop to near 0% resulted in large monthly savings for many borrowers. This, we surmise, freed up monthly income to spend on home furnishings, including for components manufactured by **Leggett & Platt (LEG)**, while auto makers including **General Motors (GM)** benefitted from a growing need for personal vehicles due to fewer public transportation options. We think GM's pivot towards fully electric and hybrid cars is permanent and suppliers like **Corning (GLW)** will continue to benefit from the shift towards vehicles with substantial technological requirements.

While the aforementioned stocks generally have performed well, we believe all of these trends are not soon to reverse, so though we are always cognizant of valuation…and we took some money off the table on a few of our stellar performers in 2020…we believe we own quality businesses that still have excellent growth potential, strong balance sheets and reasonable valuation metrics.

GOOD THINGS COME IN SMALL (AND MID) PACKAGES

The performance gap by mid-December wasn't nearly as large as it was earlier in the 2020, but small capitalization stocks (the smallest 2,000 companies in the broad Russell 3000 index) still trailed their large capitalization counterparts (the largest 1,000 companies in the Russell 3000 index) by a wide margin. Large weights in Information Technology stocks played a big role in the outperformance of large caps, but we think the bigger theme in the large vs. small comparison is the valuation gap. While not (yet) part of *The Prudent Speculator*, we offer a small- and mid-cap (SMid) managed account strategy, where the forward P/E ratio is below 15, compared with 29 for the Russell 3000 index and 24 for the Russell 3000 Value index. Our SMid strategy also looks more favorable, in our view, than the broad indexes measured by the price to sales ratio, the price to book ratio and dividend yield.

We consider small- and mid-cap companies to have market capitalizations under $20 billion at the time of purchase, and we have used the pandemic-related fallout to snap up recent *Prudent Speculator* recommendations like oil and gas explorer **EOG Resources (EOG)**, lighting manufacturer **Acuity Brands (AYI)** and luxury department store **Nordstrom (JWN)**. In fact, at the time we published the initial recommendations in our *TPS* newsletter, 10 of 15 new portfolio additions this year had market capitalizations below $20 billion.

We like small- and mid-cap stocks for their enhanced upside potential, in addition to generally less expensive valuations. Our go-anywhere approach allows us to find Value in all environments, and given the lack of love for that segment of the market earlier in 2020, we thought it a good pond in which to fish. Fortunately, the second half of 2020 has been much more friendly to smaller stocks, particularly after news of positive vaccine trials spread in early November. We believe the upswing for this segment has only just begun and we expect to add more SMid stocks to our *Prudent Speculator* buy list in 2021.

TECHNOLOGY IS THE FUTURE

The rollout of 5G is finally here. After years of development and investment, major telecom companies, such as **AT&T (T)** and **Verizon (VZ)**, have been launching their ultra-fast networks on a city-by-city basis. New 5G-capable phones, often with **Qualcomm (QCOM)** communications chips, including the latest batch of **Apple's (AAPL)** iPhones and devices powered by **Alphabet's (GOOG)** Android operating system, should result in large portions of the population upgrading to take advantage of the technology. We think 5G is remarkable for its speed and connections, which should allow consumers to get better service more often and should help content kings like **Viacom (VIAC)** and **Walt Disney (DIS)** reach wider audiences.

Of course, with lockdowns picking back up towards the end of December, we think that 5G's 'on the go' benefits aren't as important as a stable connection, particularly for those who may have subpar internet service quality or lack service at all.

Fast connectivity powered by 5G components rely on "the Cloud" to store and process massive amounts of data. The Cloud can be public or private (available to multiple organizations) and distributes computing power and data access across many locations. We believe our current holdings cover the Cloud spectrum. **Digital Realty Trust (DLR)** owns and manages data centers, **Cisco Systems (CSCO)** designs network switching equipment for traffic management, **Micron (MU)** creates fast solid-state storage devices, **Seagate (STX)** is a long-time leader in hard-disk design for large amounts of storage not needed frequently and **Intel's (INTC)** processors provide gobs of server computing power.

While the Cloud has been around for several years, we think the overall business is still in its infancy, giving companies that have fallen behind, such as **International Business Machines (IBM),** time to catch up, its prospects boosted after the company's recent Red Hat acquisition and management shake-up. With 5G connections offering ultra-fast service in many areas, we think that content owners and businesses will continue to rely on the 5G+Cloud pairing to form the foundation of computing through at least the end of this decade.

CAPITOL HILL PROVIDES CAPITAL OPPORTUNITIES

No doubt, there will be much back and forth throughout the land as America ushers in a new president in January, but we are primed for opportunities that could result from a focus on federal spending as well as a possible change in the perception of big pharma and the Health Care sector.

We figure there is a high likelihood that infrastructure spending will become a hot item at the federal level. With many on both sides of the aisle calling for a bill to overhaul and expand America's bridges, airports, networks and other infrastructure, we like the prospects for industrial firms like **Caterpillar (CAT)**, **Eaton (ETN)** and **Cummins (CMI)**.

The pendulum has likely swung in the direction of a trim to the defense budget, although some might argue that persistently low interest rates would allow the budget to remain intact while supporting other policy goals. Nevertheless, the world can still be a hostile place as enemies gain in the sophistication and complexity of their schemes, while inexpensively priced major defense contractors like **Lockheed Martin (LMT)** and **General Dynamics (GD)** could still grow profits in a scenario of budget cuts due to robust backlogs extending well into the future.

There also is the possibility that health care will be viewed in a more positive light than in recent years, given the role that **Pfizer (PFE)**, **Johnson & Johnson (JNJ)** and others have played in bringing vaccines to the world. The Health Care sector has been under regulatory scrutiny for the past several years, so even a modest lessening of the negativity is likely to be supportive, especially considering very low valuations and rich dividend yields for many of the stocks. We expect this goodwill, not to mention an increase in business, could extend to integrated pharmacy healthcare provider **CVS Health (CVS)**, which is likely to play a key role in distributing vaccines for public use.

DIVIDENDS, DIVIDENDS, DIVIDENDS!

While long-term rates have ticked up since the end of July, they remain at levels far below historical averages. In December, the yield on the 10-Year U.S. Treasury stood at less than 1.0%, and we expect the low interest rate environment to continue through at least 2021, making dividend-payers very attractive especially for folks that need to generate income with their investment portfolios. True, stocks are a volatile asset class, and capital appreciation is never guaranteed, but dividend payouts have generally risen over time, whereas fixed income coupons are usually fixed, meaning that even the current 1.6% yield on the S&P 500 might provide more long-term income than today's high quality bond portfolios. Even better, the dividend yield of our broadly diversified portfolios are much higher than the broad indexes, with TPS Portfolio's forward yield standing today at 2.4%.

We are not singularly focused on yield as we seek capital appreciation first and foremost, certainly we do not mind if companies choose to reinvest profits in growing their business or even to buy back stock…at discounted prices hopefully. Still, we own a variety of Dividend Aristocrats, which are companies that have increased dividends for at least 25 years. The list includes **3M (MMM)**, which we like for its wide variety of products and 3.4% yield, and **Archer Daniels Midland (ADM)**, which we like for its agricultural exposure and its 2.9% yield. We think elective surgeries will return, helping 2.1%-yielder **Medtronic (MDT)**, while potential opioid lawsuit resolutions and a resumption of profit growth should boost **Cardinal Health (CAH)** and its 3.4% yield. Our Dividend Aristocrat holdings also include securities mentioned elsewhere in this report: **Johnson & Johnson (JNJ), Leggett & Platt (LEG), Lowe's (LOW), Target (TGT), Caterpillar (CAT)** and **AT&T (T)**.

IT'S A GREAT BIG WORLD OUT THERE

Foreign market performance lagged the major domestic indexes in 2020, creating what we believe are significant opportunities. Developed markets have been hit especially hard, with Europe still struggling to shake the pandemic's negative impact. Fortunately, we think geographical diversification is fairly easy to implement in a broadly diversified portfolio of stocks, especially with American Depository Receipts (ADRs) traded on U.S. exchanges and foreign operations embedded in the multinational income streams for many of our U.S.-based holdings.

Looking at foreign-domiciled companies, we believe that the strong shipping environment will favor German parcel carrier **Deutsche Post (DPSGY)**, which derives 80% of revenue outside the United States. Car giant **Honda Motor (HMC)**, which derives roughly half of sales outside the U.S., should benefit from growing sales of hybrid and electric cars, a result of changing consumer tastes and successful marketing campaigns with the Helpful Honda People. Drugmaker **Sanofi (SNY)**, which earns two thirds of its revenue abroad, has a robust therapeutics pipeline and reasonable valuation metrics.

Turning our attention to U.S.-based corporations, we think the appliance refresh cycle and mellowing China tensions will help U.S.-based **Whirlpool (WHR)**, which sees 45% of annual revenue come from outside the United States. Heavy equipment maker **Caterpillar (CAT)**, which gets more than half of total sales abroad, should also benefit from a slow but sustained recovery in end-market demand. Staffing services provider **ManpowerGroup (MAN)**, which derives 67% of its revenue from Europe, should see a rebound in its business as the Continent emerges from the pandemic.

CLOSING

As the calendar turns to 2021 and as the litany of names mentioned illustrates, we continue to find plenty of undervalued companies with what we believe to be significant total return potential. Of course, one must still construct a diversified portfolio of these stocks, so we offer the reminder that we have wealth and asset management services available. After all, we have long thought that the secret to success in investing is not simply to select good stocks, but to not get scared out of them.

Vannevar Bush said, "Fear cannot be banished, but it can be calm and without panic; it can be mitigated by reason and evaluation," so for our newsletter subscribers and managed account clients, we make good use of our nerves of steel by offering extensive written perspective each week on the goings on in the equity markets. Indeed, it doesn't matter what stocks one picks if a portfolio is sitting in cash!

For more information on working with our financial professionals contact us at wealth@kovitz.com or 312.334.7300.

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The dividend-weighted portfolio data is from Eugene F. Fama and Kenneth R. French. The dataset is broken into five groups: non-dividend paying, top 30% of dividend payers, middle 40% of dividend payers, bottom 30% of dividend payers and all dividend payers (weighted 30% of top dividend payers, 40% of middle dividend payers and 30% of low dividend payers). The capitalization and factor-based (book value-to-price) portfolio data is from Eugene F. Fama and Kenneth R. French. The dataset is broken into four groups: large value, large growth, small value and small growth. The aggregate Value and Growth porfolios are monthly averages of the two returns.

The Standard & Poors 500 index (S&P 500) is a broad stock market index based on the market capitalizations of the largest 500 companies listed in the U.S. Small company stocks, via Ibbotson Associates, are the bottom twenty percent of the New York Stock Exchange. Large company stocks, via Ibbotson Associates, are represented by the S&P 500 index.

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