THE PRUDENT SPECULATOR

Small Companies, Big Potential

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Four and a half decades ago in the first edition of our *The Prudent Speculator* newsletter, Al Frank (founder of Al Frank Asset Management, which was aquired by Kovitz in 2018), wrote, "Essentially, the PS method is to 'buy low and sell high.' Low refers to 'undervalued' (in the market place) stocks, and high refers to fully- or overvalued stocks. These valuations are based upon historical, current and projected: 1) tangible book value; 2) net working capital; 3) price/earnings ratio; 4) earnings; 5) dividends and dividend policy; 6) price; 7) earned on net-worth percentage; 8) other special considerations unique to the company being analyzed (e.g., management, products, cultural trends); 9) stock market climate; and 10) the individual's needs, capacities, and portfolio. I include items 9) and 10) in the notion of valuation because it is silly to consider any equity independently of them."

While substantial analytical work has been completed on these and other quantitative and qualitative factors over the past 45 years, and new metrics have been incorporated into our processes, Al's initial framework is very much alive in the investment approach by which we manage our ValuePlus, Dividend Income and Small-Mid Dividend Value (SMiD) strategies. True, the markets have evolved over the years, but our basic premise of buying undervalued stocks and patiently holding then until they reach fair value has remained unchanged.

HISTORICAL EVIDENCE

We continue to find value in all market-cap strata, but smaller-capitalization stocks with reasonable price metrics and generous dividend yields have been largely left behind recently. That's an anomaly for many reasons, especially considering the terrific long-term performance for Small Value stocks (in Figure 1). In addition to some of our more-recent newsletter picks being of the small-cap variety, we have a SMiD strategy to better appreciate this area.

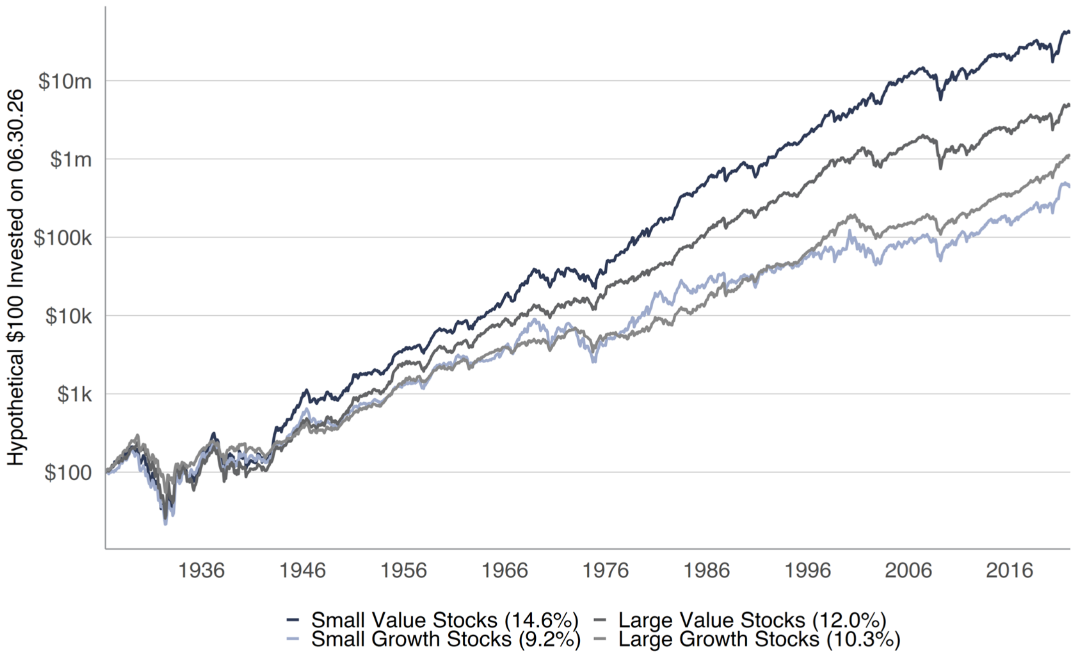


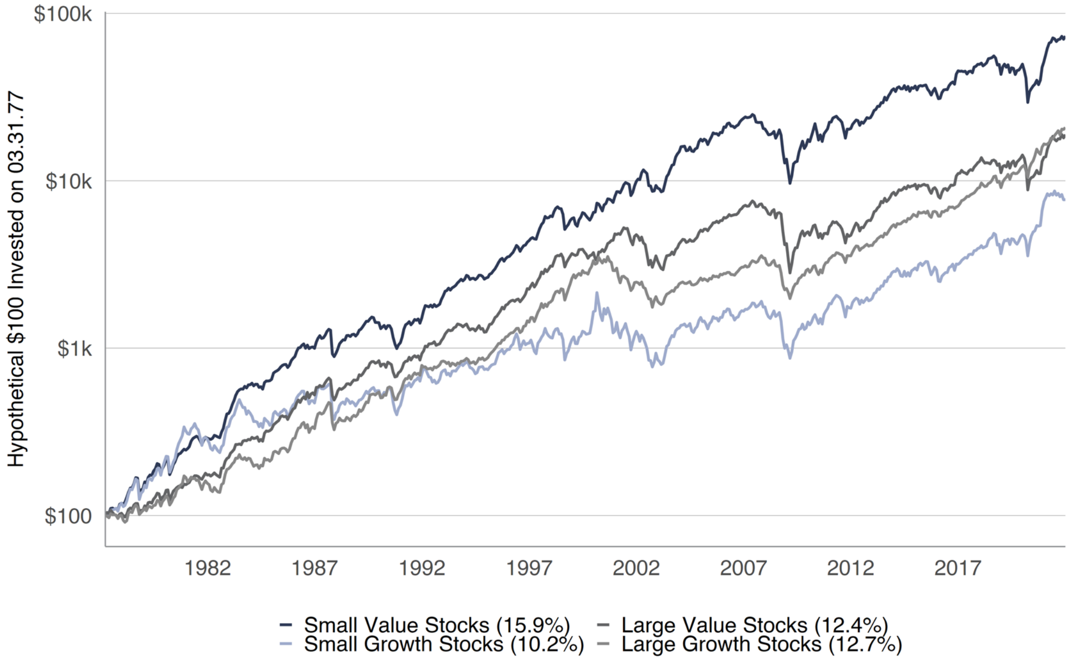
Figure 1: Ultra-Long-Term Performance since 1927
From 06.30.1926 through 12.31.2021. The portfolios are formed on Book Equity/Market Equity at the end of each June using NYSE breakpoints via Eugene F. Fama and Kenneth R. French. Logarithmic scale. SOURCE: Kovitz using data from Professors Eugene F. Fama and Kenneth R. French

SINCE 1977

Since the inaugural issue of *The Prudent Speculator* was published in March 1977, the Small-Cap Value subset of stocks (as determined by portfolios constructed by Professors Eugene F. Fama and Kenneth R. French based on size and book-to-market) have trounced the comparable Growth indexes, even as the horse race between Large Value and Large Growth over the same period has favored the latter by a neck.

Figure 2:
Long-Term Outperformance since 1977

From 03.31.1977 through 12.31.2021. The portfolios are formed on Book Equity/Market Equity at the end of each June using NYSE breakpoints via Eugene F. Fama and Kenneth R. French. Logarithmic scale. SOURCE: Kovitz using data from Professors Eugene F. Fama and Kenneth R. French



RECENT HISTORY - SMALL VS LARGE

Over the past five years, the performance gap between Small-Cap Value (market caps between $22 million and $10.1 billion on January 31) and the Large-Cap S&P 500 has been unusually wide and sits not too far above the widest gap on May 14, 2020. The tide started to turn in Q4 of last year, but there is a long way to go just to reach equilibrium, much less return Small Cap Value to its leadership position.

Figure 3:
Small-Cap Value Has Lagged Recently

From 01.31.2017 through 01.31.2022. SOURCE: Kovitz using data from Bloomberg Finance L.P.

RECENT HISTORY – MID VERSUS LARGE

The story is similar for the relative returns race since 2017 between the S&P 500 and the Russell Mid-Cap Value index. Of course, many Mid-Cap stocks have graduated into Large-Cap territory as the market capitalizations for that index ranged between $720 million and $62.3 billion on January 31, but we continue to find plenty of inexpensive names in this underfollowed section of the market.

Figure 4:
Mid-Cap Value Has Also Lagged Recently

From 01.31.2017 through 01.31.2022. SOURCE: Kovitz using data from Bloomberg Finance L.P.

DÉJÀ VU ALL OVER AGAIN

With interest rates moving higher as the Federal Reserve is poised to tighten monetary policy, there has been a collapse over the past few months in the share prices of many formerly high-flying meme stocks, special purpose acquisition companies and profitless companies, not unlike what was seen when the Tech Bubble burst in 2000. Mark Twain said, "History never repeats itself, but it does often rhyme," so we can't help but like how Small- and Mid-Cap Value performed post March 31, 2000.

Figure 5:
Performance since the Tech Bubble

Forward total returns in percent. SOURCE: Kovitz using data from Bloomberg Finance L.P.

Total Returns Matrix from March 31, 2000					
Index	1 Year	3 Years	5 Years	10 Years	20 Years
Russell 3000 Growth	-42.5	-58.7	-44.0	-33.6	119.3
Russell 3000 Value	1.5	-17.2	33.1	41.2	190.1
Russell 3000	-22.3	-40.4	-11.8	-0.7	161.0
Russell 2000 Growth	-39.8	-56.8	-28.9	-14.3	100.9
Russell 2000 Value	**19.5**	**13.4**	**104.8**	**134.6**	**274.5**
Russell 2000	-15.3	-29.5	21.7	43.6	179.9
Russell Midcap Growth	-45.4	-57.8	-31.6	-15.6	137.2
Russell Midcap Value	**13.8**	**4.7**	**87.8**	**125.2**	**352.2**
Russell Midcap	-12.0	-24.1	30.6	60.5	271.9
S&P 500	-21.7	-40.9	-14.8	-6.4	154.8

SEPARATING THE WHEAT FROM THE CHAFF

Finding attractively priced stocks with strong risk-adjusted appreciation potential in the Small- and Mid-Cap arena is not an easy task. After all, 5,480 issues traded on the New York Stock Exchange and 5,363 traded on the Nasdaq in 2021, so there are plenty of candidates, larger and smaller, from which to choose. To make it into our portfolios, stocks must pass three tests:

(1) A backward-looking quantitative screen to ensure that a company is truly value-priced by our way of thinking relative to its peers and the market in general.

(2) A qualitative review to ensure that we like the long-term prospects of the underlying business

(3) A forward-looking valuation calculation to determine a Target Price and to ensure that the upside total return potential over the next three-to-five years is sufficient relative to the risk we perceive to be inherent in the investment.

VALUE ALGORITHM

The Value Investment Committee analyzes the fundamentals supporting about 3,000 individual stocks, both domestic and international, with trading liquidity a criterion in the universe selection. The output of this fully automated review is a value scoring algorithm that incorporates a range of metrics historically indicative of future potential outperformance with daily updates of all required fundamental data for each security.

A sample of the categories of metrics the Committee reviews: Revenue, Earnings, Earnings Before Taxes, Tangible Book Value, Dividend Yield, Free Cash Flow Yield, EV to EBITDA, ROCE and ROIC.

The algorithm aggregates individual metrics into a composite stock scoring system that ranks individual stock valuations in the context of valuations among peers and the broader universe. Peer-relative scale ensures like-for-like relative valuation context. Universe-relative scale captures sector-relative over-and under-valuation trends over time.

THE NUMBERS TELL ONLY PART OF THE STORY

Our screening algorithm identifies potentially undervalued names, but the team must pick truly unique stocks with the greatest potential reward, while the upside must be sufficient to cover the risk assumed in pursuit of the opportunity. As such, our focus shifts to deeper quantitative reviews of financial strength and earnings quality and, perhaps more importantly, a qualitative review of the company.

Indeed, as we endeavor to avoid the proverbial buggy-whip maker, we consider brand strength, competitive positioning, intellectual property defensibility, management tenure, product breadth & depth and reporting quality, along with other intangible factors. No guarantee that we will find an Apple, with its now ubiquitous iPhone, but we are endeavoring to avoid stocks like Motorola, Palm and Blackberry, all of which in their day had must-have smartphones/hand-held devices.

GROWTH IS A SIGNIFICANT COMPONENT OF VALUATION

Stocks that pass our initial screening algorithm and our qualitative review are next evaluated via a forward-looking process which determines our long-term Target Prices. This is our assessment of fair value three-to-five years hence and is based on our estimates of the growth in revenue, earnings and stockholders' equity, multiplied by our determination of a reasonable price multiple for those metrics.

For a simplistic example, recent small-cap recommendation and industrial battery maker EnerSys (ENS), we think, will see its earnings per share grow from today's trailing-12-month tally of $4.57 to more than $7.00 by 2025, with potential for a significantly greater bottom-line figure by 2027. Historically, ENS has traded for a P/E ratio in the 17 range, which would produce a valuation by this metric of $119 based on $7.00 of future EPS or $136 based on $8.00 of future EPS.

Obviously, there is plenty of subjectivity in our Target Price setting, so we strive to be conservative in our estimates and multiples, while we also recognize that we are always focused on total return in our investments, meaning that the dividend income produced over the life of our holding must also be considered. Although EnerSys sports a yield of only 1%, the current

$70 or so market price offers plenty of capital gains potential in our view, while we won't complain about receiving seventeen-and-a half cents per share of income each quarter to boot.

METRICS & CONCLUSION

Broad market valuation measures are always of interest to us, but we do not rely on them. Instead, our in-house quantitative algorithms sort through time series data for thousands of stocks each day to form the foundation for our ValuePlus, Dividend Income and Small-Mid Dividend Value strategies. We believe distillation of a broad opportunity set into a consolidated list of Value stocks is analogous to "fishing in the appropriate pond."

And once the finalist candidates are determined, we scrutinize individual equities on a multitude of company-specific factors the algorithms don't assess. The result aligns with our view that there's a pocket of Value in any market environment and we remain focused on uncovering bargain-priced stocks with significant appreciation potential.

Our investment Committee has money across all of our strategies, so we do not favor one over the other, but we sure do like to eat our own cooking. Of course, with the opportunity in Small- and Mid-Cap stocks especially interesting these days, we have recently pushed more of our personal chips into our SMiD managed account portfolio.

Figure 6:
Portfolio & Index Valuation Metrics

As of 01.31.2022. Weights based on model portfolios Harmonic mean used to calculate the portfolio price metrics. Companies with negative earnings are excluded from the P/E and Estimated P/E calculations. SOURCE: Kovitz using data from Bloomberg Finance L.P.

Kovitz Value Strategy Metrics & Index Comparisons

Series	Price to Earnings Ratio	Price to Est. Earns Ratio	Price to Sales Ratio	Price to Book Ratio	Dividend Yield
TPS Portfolio	**14.8**	**13.2**	**1.2**	**2.5**	**2.2**
ValuePlus	**15.4**	**13.1**	**1.5**	**2.5**	**2.0**
Dividend Income	**13.9**	**12.8**	**1.0**	**2.3**	**2.7**
Focused Dividend Income	**15.1**	**13.9**	**1.3**	**2.6**	**2.4**
Focused ValuePlus	**14.8**	**14.1**	**1.5**	**2.7**	**2.1**
Small-Mid Dividend Value	**12.1**	**10.9**	**0.7**	**1.7**	**2.4**
Russell 3000	26.8	20.7	2.6	4.2	1.4
Russell 3000 Growth	38.0	28.5	4.4	11.4	0.7
Russell 3000 Value	20.5	16.1	1.8	2.5	2.0
Russell 2000	107.4	22.6	1.2	2.4	1.3
Russell 2000 Growth	NA	38.4	1.6	4.5	0.6
Russell 2000 Value	44.2	16.3	1.0	1.7	2.0
Russell MidCap	24.9	18.8	1.8	3.2	1.4
Russell MidCap Growth	51.5	29.1	3.2	9.1	0.6
Russell MidCap Value	19.8	15.9	1.5	2.4	1.8
S&P 500 Index	23.7	20.1	2.9	4.5	1.4
S&P 500 Growth Index	28.5	24.7	5.4	8.9	0.7
S&P 500 Value Index	20.1	16.8	2.0	3.0	2.0
S&P 500 Pure Value Index	12.2	10.8	0.7	1.4	2.4

For additional information about subscribing to *The Prudent Speculator* newsletter, please call Phil Edwards at 800.258.7786 or email pedwards@kovitz.com.

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All returns are geometric average unless otherwise stated. The geometric average is calculated using the mean of a set of products that takes into account the effects of compounding.

The federal funds rate is the rate banks charge on loans to each other.

The quoted forward yield for the S&P 500 uses the iShares S&P 500 ETF (ticker: SPY) as a proxy. The quoted forward yield for the S&P Core Value uses iShares Core S&P U.S. Value ETF (ticker: IUSV) as a proxy. The quoted forward yield for the S&P Core Growth uses iShares Core S&P U.S. Growth ETF (ticker: IUSG) as a proxy.

The 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 portfolios 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. The S&P 500 Growth Index is a market capitalization weighted index. All the stocks in the underlying parent index are allocated into value or growth. Stocks that do not have pure value or pure growth characteristics have their market caps distributed between the value & growth indices. Prior to 12/19/2005 this index represented the S&P 500/Barra Growth Index. The S&P 500 Value Index is a market capitalization weighted index. All the stocks in the underlying parent index are allocated into value or growth. Stocks that do not have pure value or pure growth characteristics have their market caps distributed between the value & growth indices. Prior to 12/19/2005 this index represented the S&P 500/Barra Value Index.

Growth stocks = 50% Fama-French small growth and 50% Fama-French large growth returns rebalanced monthly. Value stocks = 50% Fama-French small value and 50% Fama-French large value returns rebalanced monthly. The portfolios are formed on Book Equity/Market Equity at the end of each June using NYSE breakpoints via Eugene F. Fama and Kenneth R. French. Dividend payers = 30% top of Fama-French dividend payers, 40% of middle Fama-French dividend payers, and 30% bottom of Fama-French dividend payers rebalanced monthly. Non-dividend payers = Fama-French stocks that do not pay a dividend. Long term corporate bonds represented by the Ibbotson Associates SBBI US LT Corp Total Return index. Long term government bonds represented by the Ibbotson Associates SBBI US LT Govt Total Return index. Intermediate term government bonds represented by the Ibbotson Associates SBBI US IT Govt Total Return index. Treasury bills represented by the Ibbotson Associates SBBI US 30 Day TBill Total Return index. Inflation represented by the Ibbotson Associates SBBI US Inflation index.

The Russell 3000 Index is composed of 3000 large U.S. companies, as determined by market capitalization. This portfolio of Securities represents approximately 98% of the investable U.S. equity market. The Russell 3000 Index is comprised of stocks within the Russell 1000 and the Russell 2000 Indices. Russell 3000 Growth Index measures the performance of those Russell 3000 Index companies with higher price-to-book ratios and higher forecasted growth values. Russell 3000 Value Index measures the performance of those Russell 3000 Index companies with lower price-to-book ratios and lower forecasted growth values.

The MSCI ACWI Index is a free-float weighted equity index. It was developed with a base value of 100 as of December 31 1987. It includes both emerging and developed world markets. The Bloomberg Barclays Global Aggregate Index is a flagship measure of global investment grade debt from twenty-four local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging markets issuers. The DJ US Real Estate Index represents REITs & other companies that invest directly or indirectly in real estate through development, management or ownership, including property agencies. The index is a subset of the Dow Jones U.S. Index, which covers 95% of U.S. securities based on float-adjusted market capitalization. The S&P GSCI Total Return Index in USD is widely recognized as the leading measure of general commodity price movements and inflation in the world economy. Index is calculated primarily on a world production weighted basis, comprised of the principal physical commodities futures contracts.

From 1927 to present, we utilized the dividend-weighted portfolio data 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).

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