THE PRUDENT SPECULATOR

Where to Invest in 2022

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Far more COVID-19 cases, hospitalizations and deaths than anyone might have fathomed. Concerns about potential capital gains, corporate and personal income tax hikes. A couple of debt-ceiling chess matches and geopolitical twists and turns. Rising interest and inflation rates. Possible changes in the Federal Reserve's monetary policy stance.

2021 had its share of headwinds, yet equity prices enjoyed handsome gains through mid-December, with the major market averages on pace to finish well in the green. Happily, stocks appear set to blow away the median projection of 3800 offered at this time last year by Wall Street strategists for the year-end-2021 S&P 500 target level, providing more support for our long-held assertion that time in the market trumps market timing.

It follows, then, that we would agree with a prominent *Sunday New York Times* financial columnist who recently warned of the perils of prognostication. As *The Times* pointed out, "The median Wall Street forecast from 2000 through 2020 missed its target by an average 12.9 percentage points." Of course, the writer could not help himself, concluding his column with, "I don't know when it will happen or how, but at some point, the stock market will come back down to earth. That's a prediction you can count on."

Given that, on average, the S&P 500 has endured 5% pullbacks three times per year, 10% corrections every 11 months and 20% Bear Markets every 3.5 years, we can't argue with the observation that stocks will at some point move south. The only problem is knowing when those downturns will begin and, even more importantly, figuring out when the selloff has ended, especially when the issues that led one to bail out of stocks are usually even more disconcerting when it is time to get back in.

To be sure, history shows that the only problem with market timing is getting the timing right, as a trader must be right twice. Seeing as how equities have returned 10.0% (Growth stocks) to 13.3% (Value stocks) per annum since 1927, there is a lot to be said for the advice of legendary investor Charlie Munger, "The first rule of compounding is to never interrupt it unnecessarily."

So, while we are always braced for downside volatility and we respect that the Omicron variant is a new wildcard in the coronavirus battle, we see no reason to alter our optimistic view for equities as we head into 2022. However, we think that investors will need to be much more selective in their holdings in the new year, especially with the Fed Tapering underway and higher inflation readings suggesting that Jerome Powell & Co. will likely raise interest rates two or three times in 2022.

Not surprisingly, we are partial to the stocks trading for lower valuation metrics that we have long championed. In addition to the valuation gap between Value and Growth being as wide today as it was at the peak of the Tech Bubble, our study of the historical evidence suggests that higher inflation, rising interest rates and increased tax rates have previously coincided with superior performance for inexpensive stocks versus their pricier peers.

There are no guarantees that history repeats, but we sleep much better at night, given investor worries about elevated valuations for the major market averages, with the discounted metrics for our portfolios. Believe it or not, TPS Portfolio trades for respective average trailing and next-12-month P/E ratios of 16 and 14, versus 26 and 22, respectively, for the S&P 500, while the dividend yield comparison is 2.2% to 1.3%.

We do not benchmark ourselves to the S&P 500, as the Russell 3000 Value index is a much better measure of our strategy, but we suspect folks would like us to add our voice to the chorus of forecasters. With the caveat that we are much more interested in being directionally correct than nailing the exact return, we might argue for a 5% to 7% performance year for the S&P and 9% to 11% for the Russell 3000 Value index in 2022, with both sets of figures on a total return (including dividends) basis.

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 45th 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 2022.

A SHOT…OR TWO…OR THREE…IN THE ARM

Incredibly, more than 800,000 American lives have been lost and there have been more than 5 million fatalities around the world in the seven quarters since the World Health Organization declared SARS-CoV-2 a global pandemic in March 2020. And society has had to adapt to working from home, social distancing, limited travel and sporadic lockdowns, with the Thanksgiving discovery of the Omicron variant providing a vivid reminder that the coronavirus is still with us.

Of course, the rollout of multiple effective COVID-19 vaccines has allowed a return to some semblance of normalcy, while several antiviral therapeutic trials appear to be very promising in lessening the severity of the disease in those who contract the virus. True, as we pen this note, Omicron cases are surging around the world, but while the variant appears to be much more contagious, it has so far proved to be less lethal than originally feared.

Time will tell how quickly the current COVID-19 wave recedes, but most expect the pandemic to move toward endemic status sooner rather than later, with a so-called Reopening 2.0 leading to opportunities amongst recently hard-hit travel-related stocks like cruise operator **Royal Caribbean (RCL)**, aviation support firm **World Fuel Services (INT)** and air carrier **Delta Air Lines (DAL)**.

We also think that the economic rebound that began in Q3 2020 will continue in 2022, with pent-up demand and the much-better jobs picture still supporting solid levels of consumer spending, so we like retailers with staying power such as **Kohl's (KSS)**, **Tapestry (TPR)** and **Foot Locker (FL)**.

And, as COVID-19 hospitalizations eventually slow, we expect there to be big pick-up in elective surgeries, with battered medical device makers **Medtronic (MDT)** and **Zimmer Biomet (ZBH)** poised to bounce back.

SUPPLY AND DEMAND UPHEAVAL

The surprising news for much of 2021 was a significant spike in the price of many commodities, with oil up more than 40% in price as of mid-December, aluminum and copper rising 35% and 20%, respectively, and coffee, corn, cotton and sugar prices also soaring. Demand returned faster than many had expected, while the pandemic led to significantly reduced capital expenditures in many commodity-related industries. On-again, off-again reopenings of economies around the world also made it very difficult to manage inventories, and even as Christmas is imminent, dozens of ships are still anchored off the Southern California coast waiting to unload their cargos as transporting goods to market continues to be highly problematic.

While we think the extreme price volatility is not likely to stick around too much longer, especially as producers eventually scale up production for all types of inputs and consumer trends stabilize as the world eventually reopens, Omicron provided another reminder that supply chains will not easily be fixed, meaning that commodity producers like industrial gas supplier **Air Products & Chemicals (APD)**, special chemical producer **Celanese (CE)** and crop nutrients provider **Nutrien (NTR)** should enjoy plenty of pricing power for the foreseeable future.

And speaking of pricing power, the chip shortage, which has adversely impacted almost all industries in some way, was a product of steep order cancellations during the early part of the pandemic, huge near-term demand and limited ability for the fabs to scale quickly. Indeed, supply generally is not turned on with the flick of a switch, and industry titan **Intel (INTC)** suggested that it could see the shortage potentially extending into 2023, so we continue to think semiconductor stocks like chip-equipment providers **Kulicke & Soffa (KLIC)** and **Lam Research (LRCX)**, as well as semiconductor makers **Broadcom (AVGO)** and **Micron Technology (MU)** will enjoy a longer up-leg to the cycle than the market is presently pricing in.

THE FED SLOWS DOWN THE REFILLING OF THE PUNCH BOWL

The November CPI reading of 6.8% inflation, the largest year-over-year increase in 39 years, appeared to be the straw that broke the "transitory" camel's back at the Federal Reserve. Indeed, in mid-December, Jerome Powell & Co. elected to double the pace of the tapering of its bond purchase program (from $15 billion to $30 billion per month) and suggested that there could be as many as three hikes in the Federal Funds rate in 2022.

Apart from potentially higher longer-duration rates, we think the hawkish adjustment by the nation's monetary authority ought to boost loan growth (which has been lacking for much of the pandemic), as consumers and businesses look to lock in loans before rates rise. This should benefit regional banks like **Citizens Financial (CFG)** and **Bank OZK (OZK)** that derive a significant portion of their income from the spread on interest earned from loans versus the costs paid on deposits. True, increases in short-term rates could affect funding costs, but we note that many (if not most) banks in our universe boast significant deposit balances relative to the loans on their books, so they have less of a need to aggressively raise incentives to attract more money.

Not to be overlooked is that most bank balance sheets are in fantastic shape, with plenty of loan-loss reserves and low levels of non-performing assets. In addition, the large money-center banks with diversified revenue streams, including **Bank of America (BAC)**, **JPMorgan (JPM)** and **Citigroup (C)**, also have reach extending to corporate and municipal issuers looking to finance investment at relatively cheaper rates.

To be sure, volatility in the U.S. Treasury yield curve will often drive daily movements of stocks in the financial sector. Of course, the group outperformed during the last Fed Tapering cycle (2012-2014) as longer-term government bond prices fell and yields rose with Uncle Sam's reduced buying pressure, so we do not want to forget that higher interest rates have also been a tailwind for insurance companies like **Allianz (ALIZY)**, **MetLife (MET)** and **Prudential Financial (PRU)**.

EV'S ARE ACCELERATING…BUT THE ROAD AHEAD IS LONG

Electric cars are hardly new, first appearing on roads (if they can be called that) in the early 19th century, but they fizzled out in favor of combustion engines due to the need for greater range and higher speeds. Major manufacturers like AMC, **Honda**

(HMC), **General Motors (GM)**, Ford and Toyota all took some half-hearted cracks at the technology, but it wasn't until Elon Musk's Tesla came along with a Lotus-based Tesla Roadster in 2008 that EVs started to gain traction.

The discovery, and subsequent fallout from **Volkswagen's (VWAGY)** 'Dieselgate' scandal, triggered a mad dash to develop electric vehicles, which aren't exactly zero-emission (the energy must come from somewhere), but they have promise to improve the business of people-moving on many fronts. Of course, we've kept our eye on Tesla over the past decade but haven't found it to be in the fundamental Value camp—or even close to it—at any time.

Despite starting very far behind, the major automakers are racing to catch up and deploying the capital necessary to make it happen. Fortunately, consumers have noticed and are rewarding the likes of Volkswagen and General Motors in such a strong way that many brands are moving up their 'electrification' plans by years, which is telling, considering carmakers are not known for being nimble. Governments are getting a move on too, funding infrastructure improvements, providing consumer subsidies and offering tax breaks.

The average new car costs more than $40,000 these days, which at a household level could easily be the second-largest expense behind housing costs and deserves attention, but the EV boom does not mean that the conventional energy businesses are dead men walking, especially as more than two thirds of U.S. energy is consumed by a sector other than transportation. The opposite, we think, as lower investment in conventional sources and solid demand have resulted in higher energy prices across the board. Layering on frequent geopolitical spats over production levels and challenges finding new low-cost wells, we expect a flat-demand environment with tightening supply will result in higher prices overall, and therefore enhanced profitability for the likes of **ExxonMobil (XOM)** and **EOG Resources (EOG)**.

Even the oil majors are advancing new "green" technologies and the R&D is being fueled by lucrative cash flow from existing revenue that is also utilized to fund generous shareholder capital return initiatives. Still, we think there will for some time to come be millions of new ICE cars driving billions of miles and those cars, trucks and SUVs will not only sell well, but also will need to be powered by gasoline, perhaps supplied by **TotalEnergies (TTE)**, and propelled by **Cummins (CMI)** engines.

TECHNOLOGY IS THE FUTURE

The rollout of 5G communications technology should continue to benefit major telecom outfits like **Verizon (VZ)**, which generally stayed focused on its infrastructure and did not wade into the expensive content war like some peers did. 5G-capable phones are prevalent, often built with **Qualcomm (QCOM)** communications chips, and include the recent generation of **Apple's (AAPL)** iPhones and devices powered by **Alphabet's (GOOG)** Android operating system. City-dwellers should benefit the most in the beginning from the technology's speed advantage, where 5G (or 4G in some cases) is easier to deploy than in-ground connections in rural areas.

We expect to see continued interest in **Digital Realty Trust (DLR)**, an owner and manager of data centers, **Cisco Systems (CSCO)**, a designer of network switching equipment, and hard-disk manufacturer **Seagate (STX)**. Unfortunately, Intel struggled to retain market share against very capable competition, an effect we think will persist over the near term. However, longer-term investors will find the shares heavily discounted against INTC's peer group, and any indications that the company's turn-around effort is working should send shares soaring.

If "supply chain issues" became the universal excuse of 2021, then "cloud" was a universal winner. Subscription models paired with cloud hardware and software packages proved tremendously profitable for **Microsoft (MSFT)**, **NetApp (NTAP)** and **Oracle (ORCL)**, and we think the impact of a wide-scale technological rotation to on-demand computer processing capabilities will continue for many years.

IT'S A GREAT BIG WORLD OUT THERE

With foreign market performance healthy in 2021, but still generally lagging the major domestic indexes, we think significant opportunities still exist to pick up selected and what we believe to be temporarily depressed bargains. Diversification by

geography is valuable, in our view, and fairly easy to implement, 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.

We take advantage of this ability with our ownership in a variety of foreign companies, from German parcel carrier **Deutsche Post (DPSGY)**, which derives 80% of revenue outside the Americas, to French drugmaker **Sanofi (SNY)**, which earns two thirds of its revenue abroad, has a robust therapeutics pipeline and reasonable valuation metrics. We replaced General Electric with **Siemens AG (SIEGY)** in 2015, with the expectation that large, state-sponsored infrastructure projects would be necessary in many parts of the world (80% of revenue is non-U.S.). For Siemens, the wins have been lumpy, but the dividend yield is high and growing interest in environmentally friendly projects play right into SIEGY's hand.

Turning our attention to U.S.-based corporations, heavy equipment maker **Caterpillar (CAT)** gets more than half of total sales abroad, with the company likely to continue to benefit from a healthier global economy and increases in end-market demand. Finally, 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.

GOOD THINGS COME IN SMALL (AND MID) PACKAGES

While small capitalization stocks (defined as the smallest 2,000 companies in the broad-market Russell 3000 index) had enjoyed very good performance over the first nine months of 2021, the fourth quarter saw a sharp pullback through mid-December. The declines put the Russell 2000 index on track for its 5th year in a row of runner-up status versus the large-cap Russell 1000 index, adding to the valuation gap between the two and creating more chances to pick up overlooked gems.

While our all-cap value *Prudent Speculator* strategies include small and mid-cap names, we also offer our asset management and wealth management clients a Small-and-Mid-Cap Dividend (SMiD) managed account strategy, where the forward P/E ratio on the portfolio is near 11, compared with 23 for the Russell 1000 index and 17 for the reasonably priced Russell 3000 Value index.

Considering our SMiD strategy, a few names we highlight for 2022 are electronic component distributor **Avnet (AVT)**, energy concern **Civitas Resources (CIVI)**, regional bank **Eagle Bancorp (EGBN)** and medical device maker **Utah Medical Products (UTMD)**.

Spanning our ValuePlus and Dividend Value strategies, we favor *Prudent Speculator* recommendations like discount retailer **Big Lots (BIG)**, industrial battery producer **Enersys (ENS)**, railcar manufacturer **Greenbrier Cos (GBX)** and optical and photonic product supplier **Lumentum (LITE)**.

While historically more volatile, we like small- and mid-cap stocks for their enhanced upside potential, in addition to the generally less expensive valuations. Our go-anywhere approach allows us to find Value across the equity universe and we think the SMiD pond is presently a well-stocked one in which to fish.

CLOSING

As the calendar turns to 2022 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, we make more money from the stock holding than the stock picking.

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

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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.

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