THE PRUDENT SPECULATOR

Stay the Course

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After gaining more than 120% between March 23, 2020 and January 3 of this year, the S&P 500 index, a benchmark of the 500 largest companies in the U.S., has fallen nearly 20% over the last four months. In addition to the War in Ukraine, a sharp uptick in inflation, which has been climbing rapidly for a year and hit a high of 8.5% in March, has weighed on consumers and businesses, and led the Federal Reserve to hike interest rates as it tightens monetary policy.

Certainly, downturns can be scary, even though index returns since 1925 show that respective drops of 10%, 15% and 20% have occurred every 11 months, 25 months and 3.5 years, on average. It also takes longer for the index to rise than fall, with 10% gains taking nearly 250 calendar days on average, compared to around 100 days for 10% losses. For respective 15% advances and declines, it takes on average more than 500 days and 200 days. Bear Markets happen even quicker – 286 days –with 20% or greater advances lasting 995 days, on average. The good news, however, is that the magnitude of the rallies has dwarfed the setbacks, with the average gain in Bull Markets more than three times as large as the average loss in Bear Markets.

Q1 EARNINGS SEASON

With all the disconcerting news, it would be easy to miss the broadly positive figures reported over the Q1 earnings season, even as 'supply chain issues' in some form were once again *raison du jour* this past quarter for soft C-suite guidance. iPhone-maker Apple, known for aggressive management of its supplier network, warned that supply chain challenges are expected to cause a $4 billion to $8 billion revenue-whack in the current quarter. Shares of retail giant Amazon were clobbered after the company's weaker-than-expected outlook included warnings of wage inflation, soaring transportation costs and supply chain disruptions. Streaming giant Netflix thankfully did not blame supply chain challenges for its 200,000 net subscriber losses, far below guidance of 2.5 million net additions. The result of the first quarterly subscriber loss in a decade was a one-day -35% plunge, part of a drop this year of close to 70%.

Year-to-Date S&P 500 Index Attribution

Company	Average Index Weight (%)	Contribution to Index Return (%)	Company	Average Index Weight (%)	Contribution to Index Return (%)
Exxon Mobil	0.91	0.30	Microsoft	5.92	-1.35
Chevron	0.78	0.25	Apple	6.92	-1.19
ConocoPhillips	0.33	0.10	Amazon	3.50	-1.17
Abbvie	0.71	0.09	Alphabet	4.09	-0.80
Merck	0.55	0.09	Meta Platforms	1.48	-0.78
Occidental Petrol	0.12	0.08	NVIDIA	1.58	-0.71
Bristol-Myers	0.41	0.08	Tesla	2.06	-0.62
Coca-Cola	0.65	0.06	Netflix	0.43	-0.45
EOG Resources	0.18	0.05	PayPal	0.38	-0.31
Valero Energy	0.10	0.05	Home Depot	0.94	-0.29
Top 10 Total	**4.73**	**1.15**	**Bottom 10 Total**	**27.30**	**-7.67**

Figure 1: There Were Winners and There Were Losers
From 12.31.2021 through 05.13.2022. For attribution purposes, the S&P 500 is represented by the SPDR S&P 500 ETF (SPY), an exchange-traded fund that tracks the S&P 500 index. Figures may not sum due to rounding. Source: Kovitz via Bloomberg Finance L.P.

Even those companies that performed very well in Q1 and were upbeat in their guidance ran into headwinds. Electric vehicle maker Tesla turned in better-than-expected and record EPS, stating, "In the first quarter, we produced over 305,000 vehicles and delivered over 310,000 vehicles, despite ongoing supply chain challenges and factory shutdowns," yet the stock price has dropped by more than a quarter this year. No doubt, a trailing-12-month P/E ratio of more than 75, a forward-earnings multiple of greater than 50 and massive share sales by founder Elon Musk as he raises money to finance a bid for Twitter, have more to do with the selloff in Tesla than did the Q1 results.

We disaggregate the S&P 500's performance by company through the middle of May in Figure 1, while Figure 2 breaks performance down by sector. Soaring energy prices resulted in massive Energy sector profits, despite its small weight in the index. Consumer Staples ended the first four-plus months with breakeven performance, led by Coca-Cola and Phillip Morris Int'l. A substantial number of companies in the Info Tech sector with big weights and lackluster outlooks heavily detracted from performance. The rightmost five columns of Figure 2 show summary data for 457 of the 500 companies in the S&P

Figure 2: Big Headwinds in Q1; Decent Overall Results

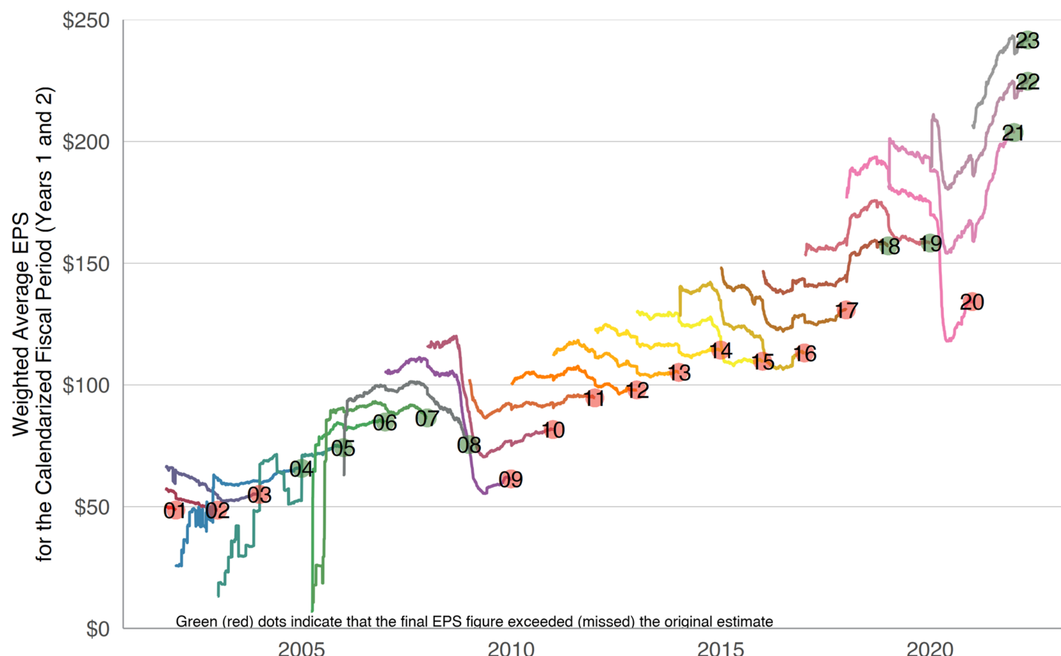
Attribution is from 12.31.2021 through 05.13.2022. Earnings results and surprises are through the morning of 05.15.2022. For attribution purposes, the S&P 500 is represented by the SPDR S&P 500 ETF (SPY), an exchange-traded fund that tracks the S&P 500 index. Earnings and sales surprise total figures in the last row are a weighted average. Figures may not sum due to rounding. Source: Kovitz via Bloomberg Finance L.P.

Year-to-Date S&P 500 Index Attribution & Earnings Analysis

Sector	Average Index Weight (%)	Contribution to Index Return (%)	Share of Companies with Q1 Reported	Sales Surprise Positive (%)	Sales Surprise (%)	Earnings Surprise Positive (%)	Earnings Surprise (%)
Energy	3.74	1.22	21/21	57.1	4.2	71.4	1.3
Utilities	2.66	0.01	29/29	82.8	10.1	62.1	1.7
Consumer Staples	6.27	0.00	25/32	80.0	4.2	92.0	8.8
Materials	2.61	-0.22	28/28	92.9	3.8	71.4	9.5
Real Estate	2.73	-0.46	30/30	63.3	2.1	76.7	6.6
Industrials	7.77	-0.90	68/71	73.5	0.9	88.2	1.2
Health Care	13.55	-1.08	62/65	77.4	3.0	77.4	8.0
Financials	11.3	-1.53	66/66	38.5	1.4	75.4	5.9
Comm. Services	9.47	-2.50	22/23	27.3	-0.3	72.7	4.0
Consumer Discr.	11.86	-3.30	44/59	59.1	0.4	59.1	-2.4
Information Tech	27.82	-6.32	62/76	80.6	2.6	80.6	5.1
Total	**99.78**	**-15.16**	**457/500**	**67.1**	**2.4**	**76.3**	**5.1**

Figure 3: Estimates aren't Perfect, but EPS Marches Higher

From 10.09.2001 through 04.30.2022. Each year's line for Bloomberg earnings per share (EPS) estimates cover three years: two years years out (or earliest available) plus the year for which the estimate is measuring. SOURCE: Kovitz using data from Bloomberg Finance L.P.



500 that have reported Q1 results. While management teams were cautious in their outlooks, we think the quarterly reports have been very good. Sales and earnings surprises averaged +2.4% and +5.1%, respectively, meaning companies tended to outperform analyst expectations. In addition, the "beat" rate has been higher than usual, and big price whacks for some companies leave us excited to go shopping for stocks on sale.

ANALYST ESTIMATES LOOK NEAR, NOT FAR

Bearing in mind that the average sell-side research report for external publication usually has a one-year (or shorter) price target (compared to our preferred target price estimates that look out 3-to-5 years or more), S&P 500 earnings have climbed handsomely over the years, even if analyst consensus earnings projections miss the mark from time to time. And since Figure 3 shows it's virtually impossible to consistently project near-term earnings for the S&P 500 index with precision, we suggest any assertion to the contrary should be met with a truckload of suspicion. For our wealth management and asset management clients, we prefer to lean heavily on the idea that long-term trends do a better job informing investment decisions for long-term investors. We suggest two take-home messages for Figure 3. The first is that group think (aka 'consensus') can be inaccurate, sometimes substantially so. Secondly, S&P earnings have risen dramatically over the most recent two decades, even though stocks always seem to be climbing a Wall of Worry. A near-term drop, even if it's steep, shouldn't scare any long-term investor.

TIME IN THE MARKET TRUMPS MARKET TIMING

With the consensus often wrong on corporate profits, is it any wonder that investors have great difficulty timing their moves into and out of stocks? Unfortunately, folks must be right twice and the evidence, as shown in Figure 4, is convincing that far too many investors end up buying high and selling low, with this phenomenon including both stocks and bonds. Per data analytics firm DALBAR, equity fund investors had awful relative returns in 2021, gaining only 18.4% on average, compared to a 28.7% return for the S&P 500, for a whopping 1030 basis point (10.3%) difference in performance. The longer-term historical numbers are even worse for bonds as Fixed Income fund investors had an annual return 500 basis points lower than the U.S. Aggregate Bond index over the past three decades. No doubt, there is a reason that we like to say the only problem with market timing is getting the timing right!

DON'T SELL, MORTIMER!

In the iconic 1983 Wall Street movie *Trading Places*, investor brothers Randolph and Mortimer Duke of Duke & Duke lost their entire fortune after wagering on short-term orange juice futures. The crop report upon which the brothers based their bets turned out to be fake, and the film's heroes Billy Ray Valentine (played by Eddie Murphy) and Louis Winthorpe (played by Dan Aykroyd) made a fortune. Like the Duke's orange juice contract debacle, we generally find short-term equity trading (which

Figure 4: Individual Investors Returns Don't Measure Up

From 12.31.1984 through 12.31.2021. Annualized returns. SOURCE: Kovitz using data from DALBAR and Bloomberg Finance L.P.

Individual Investor Returns vs. Broad Benchmarks

	Stocks			Bonds			Inflation
Time Period	Average Equity Investor Return	S&P 500 Return	Difference	Average Bond Investor Return	U.S.	Difference	U.S. Consumer Price Index
1 Year	18.4%	28.7%	-10.3%	-1.6%	-1.5%	-0.1%	7.0%
3 Years	21.6%	26.1%	-4.5%	1.7%	4.8%	-3.1%	3.5%
5 Years	14.8%	18.5%	-3.7%	0.8%	3.6%	-2.8%	2.9%
10 Years	13.4%	16.6%	-3.2%	0.4%	2.9%	-2.5%	2.2%
20 Years	8.1%	9.5%	-1.4%	0.4%	4.3%	-3.9%	2.3%
30 Years	7.1%	10.7%	-3.6%	0.3%	5.3%	-5.0%	3.4%

we would quantify as a year or less) to be deleterious to growing one's wealth. And for those who retort that it worked for Mr. Valentine and Mr. Winthorpe, we should mention that their gains were actually ill-gotten, given their possession of illegal inside information.

Fortunately, as is shown in Figure 5, the odds of a positive return are strongly in the favor of long-term investors—those who hold for one month have a 63% chance of making money with Value stocks, but increase the holding period to 1 year and the odds of success rise to 73%, with 89% the profitability rate for five-year holding periods. Believe it or not, 100% of Value portfolio returns have been positive over any 15- or 20-year period since 1927 according to data from Professors Eugene Fama and Kenneth French. Needless to say, we believe the most reliable way to create or grow a fortune in equities is with a long time horizon, a solid framework to incorporate new thinking into allocation and investment decisions and the discipline to stick with a sound financial plan.

Figure 5: In for the Long Haul: Patience is Virtuous

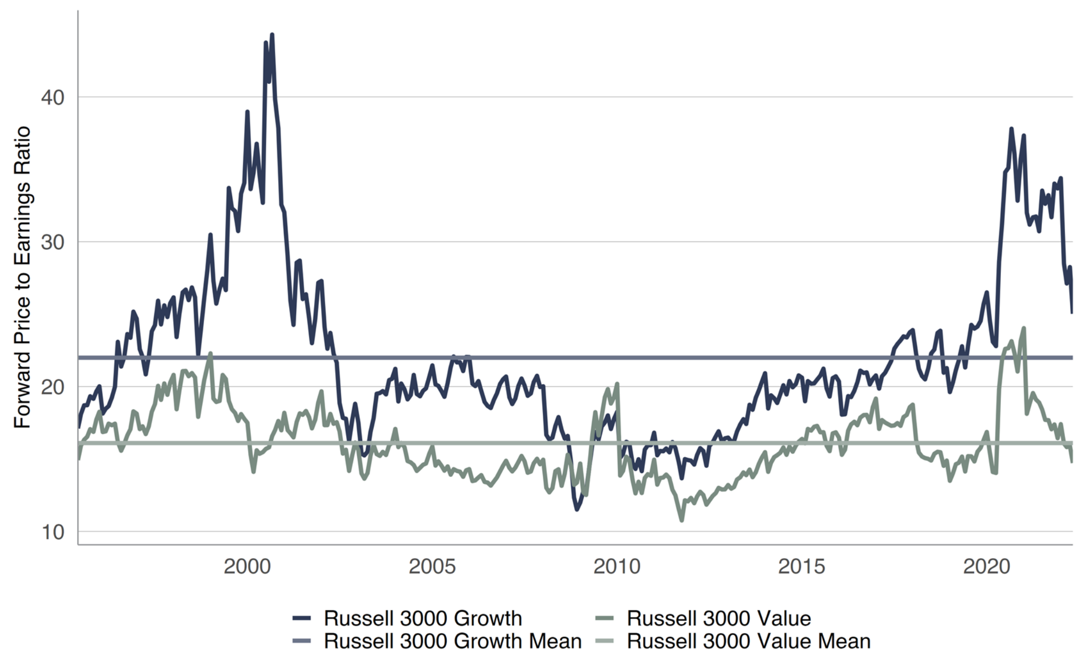
From 06.30.1927 through 02.28.2022. A three-year rolling window is defined as one 36-month period. For example, the first three-year rolling period began on 07.01.1927 and ended on 06.30.1930. Each month thereafter begins a new three-year window. The same logic is applied for other rolling windows listed in the table. SOURCE: Kovitz using data from Professors Eugene F. Fama and Kenneth R. French

Investment Success by Rolling Windows

Rolling Window	Value Stocks Positive Return Count	Value Stocks Negative Return Count	Value Stocks Percent Positive	Value Stocks Percent Negative	Dividend Payers Positive Return Count	Dividend Payers Negative Return Count	Dividend Payers Percent Positive	Dividend Payers Percent Negative
1 Month	719	418	63.2%	36.8%	721	416	63.4%	36.6%
3 Months	770	365	67.8%	32.2%	791	344	69.7%	30.3%
6 Months	805	327	71.1%	28.9%	821	311	72.5%	27.5%
1 Year	824	302	73.2%	26.8%	857	269	76.1%	23.9%
3 Years	963	139	87.4%	12.6%	944	158	85.7%	14.3%
5 Years	965	113	89.5%	10.5%	992	42	95.9%	4.1%
10 Years	984	34	96.7%	3.3%	983	35	96.6%	3.4%
15 Years	958	0	100.0%	0.0%	958	0	100.0%	0.0%
20 Years	898	0	100.0%	0.0%	898	0	100.0%	0.0%

Figure 6: Value Stocks Remain Highly Attractive

From 05.31.1995 through 04.30.2022. SOURCE: Kovitz using data from Bloomberg Finance L.P



We understand the S&P 500's drop this year might be disconcerting, but those who pay attention to equity valuations should take comfort (as shown in Figure 6) in the fact that Value stocks are today trading below their historical norm on an earnings basis, while their much more expensive Growth peers are trading above their historical average.

That does not mean that there won't be more tough sledding in the near term, but we consider the stock market's periodic ebbs to bring opportunity, while our steadfast commitment to Value investing over the last forty-five years remains the foundation of everything we do. Still, we have evolved over that time, adding arrows to the quiver and replacing pencil-and-paper valuation models with powerful quantitative capabilities.

Come what may, we remain confident that, as Warren Buffett states, "If a business does well, its stock will eventually follow."

POSTSCRIPT

We know that not everyone possesses nerves of steel, so we think that there is great value in not going it alone, but instead working with a professional partner to assist in keeping one's goals on track. Jason Clark and John Buckingham partner with clients, investing in a wide variety of strategies tailored for individual situations and taking into account factors like time horizon, risk tolerance and personal goals.

Kindly give Jason a ring at 949.424.1013 for more information on our wealth and asset management offerings, and note that all our investment professionals have significant assets invested in Kovitz strategies, which means that our interests align with those of our clients.

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.

Russell's methodology for their Value and Growth indexes is the following: For each base index (the Russell 1000 and Russell 2000, and the smallest 1,000 in Russell Microcap), stocks are ranked by their book-to-price ratio (B/P), their I/B/E/S forecast medium-term growth (2 year) and sales per share historical growth (5 year). These rankings are converted to standardized units, where the value variable represents 50% of the score and the two growth variables represent the remaining 50%. They are then combined to produce a composite value score (CVS). Stocks are then ranked by their CVS, and a probability algorithm is applied to the CVS distribution to assign growth and value weights to each stock. In general, a stock with a lower CVS is considered growth, a stock with a higher CVS is considered value and a stock with a CVS in the middle range is considered to have both growth and value characteristics, and is weighted proportionately in the growth and value index. Stocks are always fully represented by the combination of their growth and value weights.

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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