THE PRUDENT SPECULATOR

The Most Important Charts for 2022

JANUARY 2022

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"Read last year's forecasts before you take next year's too seriously," advised Morgan Housel, a partner at The Collaborative Fund, to his Twitter followers. Sound advice, we think, even as our desks are stacked high with 2022 Outlooks to read from all of the major banks and investment houses. We even penned an outlook for readers of our newsletter, *The Prudent Speculator* (available gratis here). But we think investment shops often focus too much on the near term and skimp on the long term. It would be more valuable to highlight longer-term trends and themes, such as those we consider in the management of our TPS and ValuePlus portfolios. We insist our long-termism isn't just for the outlook and is an important part of our investment processes, which expect to hold new positions three to five years or more.

Fortunately, we are not the only ones to notice the benefits of long-term investing. Using data from Professors Eugene F. Fama and Kenneth R. French, we find that Value stocks had a 63% chance of earning a positive return for any one month since 1927. Expanding the holding period to five years, the positivity rate jumps to 89.5% and holders of Value stocks over 15 years or more have never experienced losses. Growth stocks experience similar results, even though Growth stock returns have trailed Value stock returns over the last century. Yes, past performance is not predictive of future returns, but we like our odds and believe historical evidence helps support our insistence on fishing in the Value pond.

DON'T ABANDON SHIP

One of the best illustrations showing annual stock market gyrations is offered below. The red dots mark the low point each year from peak to trough and the navy bar is the final return for that year. In no year did the S&P 500 finish at its low point, and we suspect those that bailed out of equities in 2020 after the bottom fell out in March are doing some major face-palming.

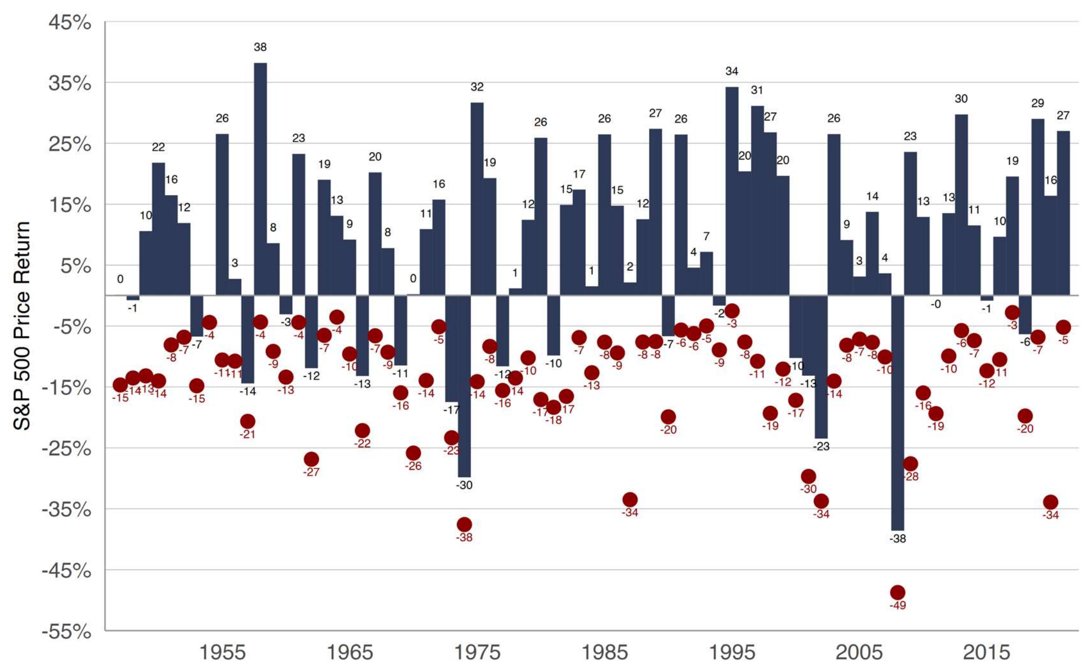


Figure 1: There Can Be Bumps in the Investing Road

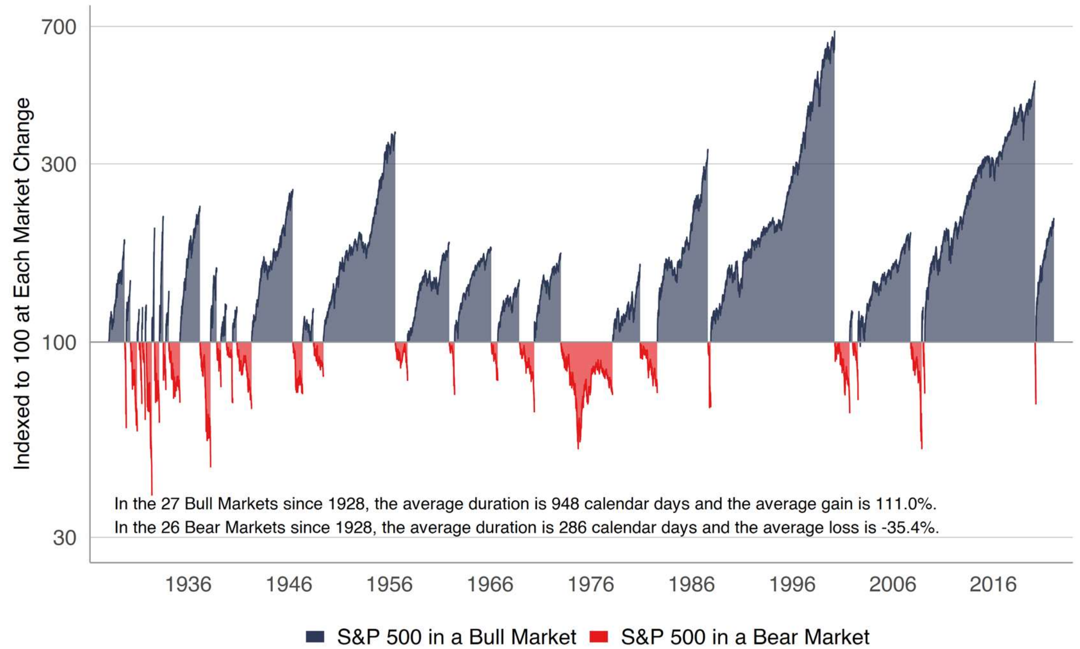
From 12.31.1946 through 12.31.2021. Price returns do not include dividends. Intra-year drops refer to the largest drops between high and low close prices during a calendar year. SOURCE: Kovitz using data from Bloomberg Finance L.P.

THE FEAR OF LOSS VERSUS THE FEAR OF MISSING OUT

Bear Markets (a 20%+ price decline from the prior peak in the S&P 500) have occurred frequently since 1928 (every 3.5 years or so) and have been relatively short, lasting just 286 days on average compared to the Bull Market average length of 948 days. We do appreciate the emotional toll a Bear Market can take on investors and we do not enjoy them either, but we suspect waiting for a pullback to deploy capital can be more damaging to returns than the Bear Market itself.

Figure 2: Waiting for a Bear Market Can Be a Risky Strategy

From 12.31.1928 through 12.31.2021. Logarithmic scale. The S&P 500 index performance is represented by the price return series. SOURCE: Kovitz using data from Bloomberg Finance L.P.

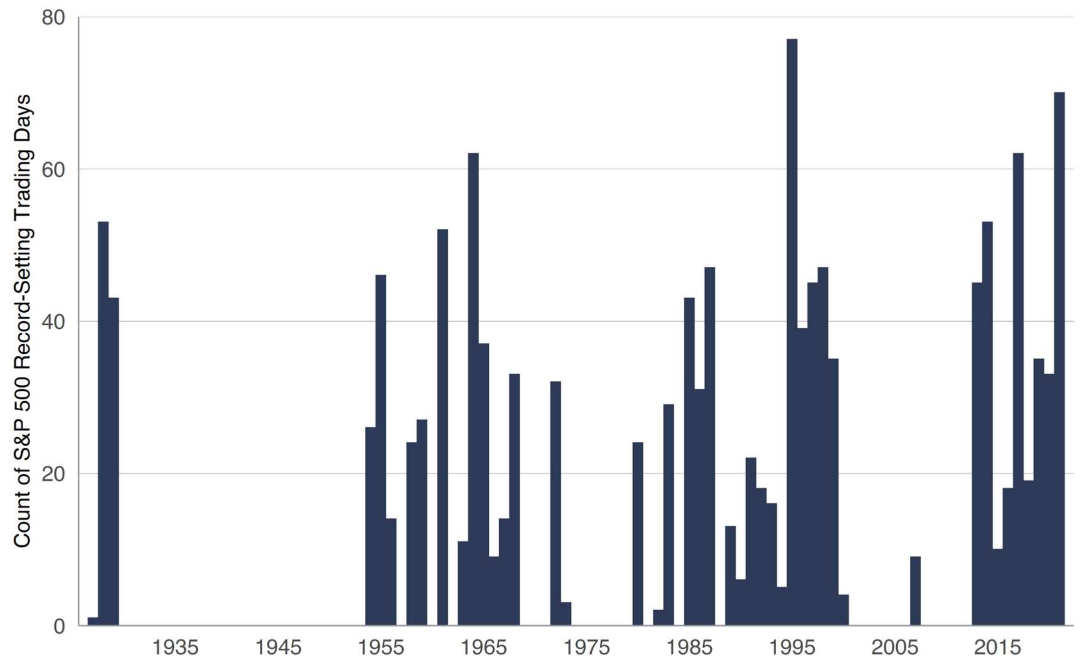


THE TEMPTATION TO WAIT

It was tempting to want to accumulate cash at the end of 2020, with the feeling the market had "come too far, too fast" cropping up in a large percentage of the 2021 outlooks we read. But those that succumbed to the temptation would have missed out on the 70 all-time highs set in 2021 by the S&P 500, missing the record of 77 set in 1995. We don't pretend to know the future, but we again like our odds of future records given that the index's annualized return since 1927 is 10.3%.

Figure 3: S&P 500 Record-Setting Days by Year

From 12.30.1927 through 12.31.2021. The S&P 500 index performance is represented by the price return series. SOURCE: Kovitz using data from Bloomberg Finance L.P.

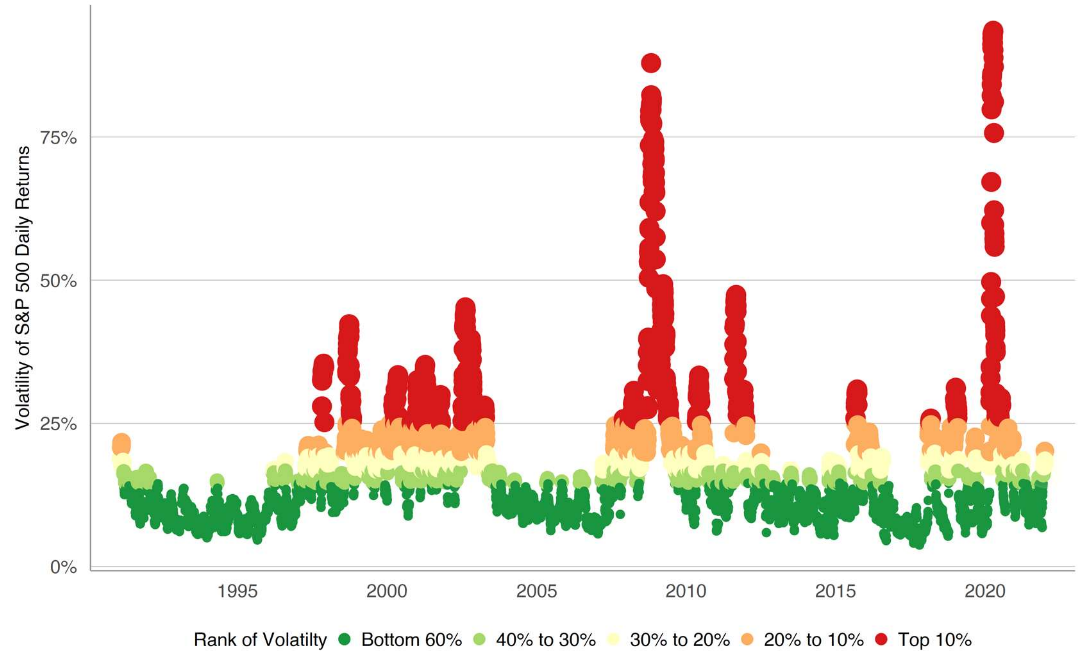


VOLATILITY HAS CALMED

As COVID-19 infections spread around the world, volatility soared in 2020 to levels not experienced since the Great Recession. While news of the omicron variant didn't help calm any nerves, volatility remains on the low end of the spectrum. Equities always seem to be climbing the Wall of Worry, and as a result we see spikes in volatility as opportunities to enhance our portfolios, rather than bail on our long-term investments.

Figure 4:
Volatility Has Receded to More Normal Levels

From 12.31.1990 to 12.31.2021.
SOURCE: Kovitz using data from Bloomberg Finance L.P.

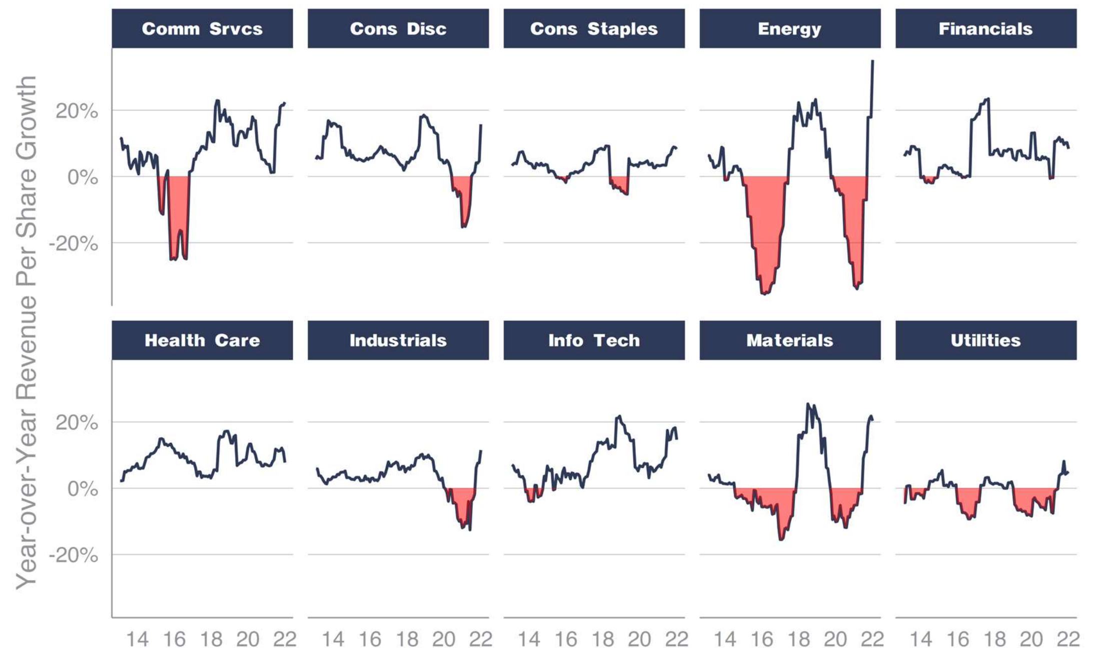


MANY SECTORS ARE STILL GROWING

The pandemic-related fallout impacted equities differently, depending on the sector. For the Information Technology, Health Care and Communication Services (which has a hefty weight in high-flying Alphabet, Facebook—now Meta Platforms—and Netflix) sectors, the pandemic resulted in strong growth, while the Energy, Materials and Industrials sectors have suffered. We would not be surprised to see some of the struggling sectors bounce back to growth.

Figure 5:
S&P Revenue Growth Wasn't in All Sectors

From 12.31.2011 to 12.31.2021. Sectors based on the Global Industry Classification Standard (GICS). SOURCE: Kovitz using data from Bloomberg Finance L.P.

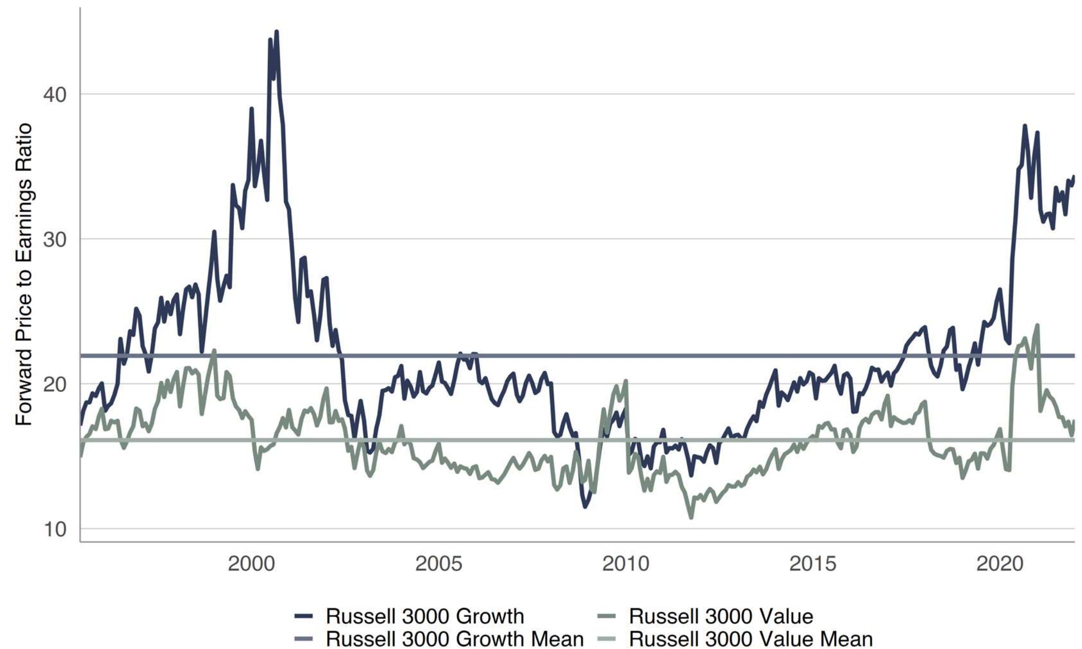


VALUE STOCKS REMAIN ATTRACTIVE

One of the most common valuation metrics, the Price-to-Earnings (P/E) ratio measures the price an investor pays for a unit of earnings. Value stocks, a group with lower P/E ratios, have seen their ratios rise, but not as much as Growth stocks, the group with high P/E ratios. The last time the valuation gap (the difference between the Growth P/E and the Value P/E) was this wide was around the New Millennium, which was the beginning of a terrific run for Value investors.

Figure 6:
Value Stocks
Remain Highly Attractive

From 05.31.1995 through 12.31.2021. SOURCE: Kovitz using data from Bloomberg Finance L.P

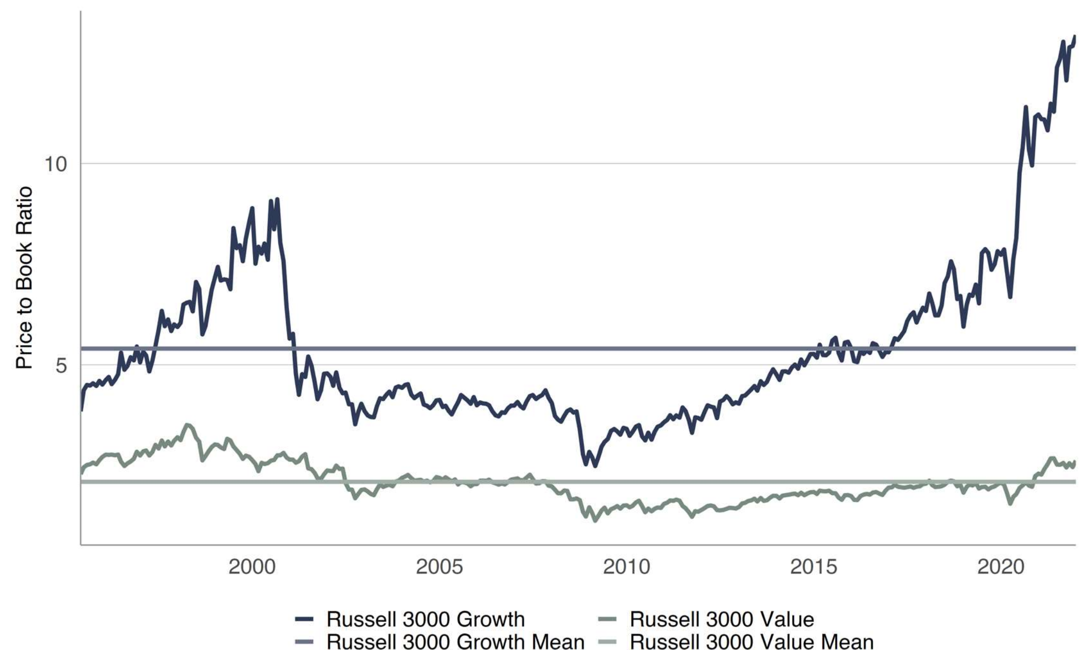


P/E ISN'T THE ONLY MEASURE

Another measure frequently used in an academic classification of Value and Growth stocks is the Price-to-Book ratio. It measures the difference between a company's market value (i.e. market capitalization) and book value (assets less liabilities). The valuation gap is even wider for P/B ratios than P/E ratios. And just like in Figure 6, the last time the gap was this wide was around the New Millennium.

Figure 7:
Growth Stocks
Have Become Expensive

From 05.31.1995 through 12.31.2021. SOURCE: Kovitz using data from Bloomberg Finance L.P

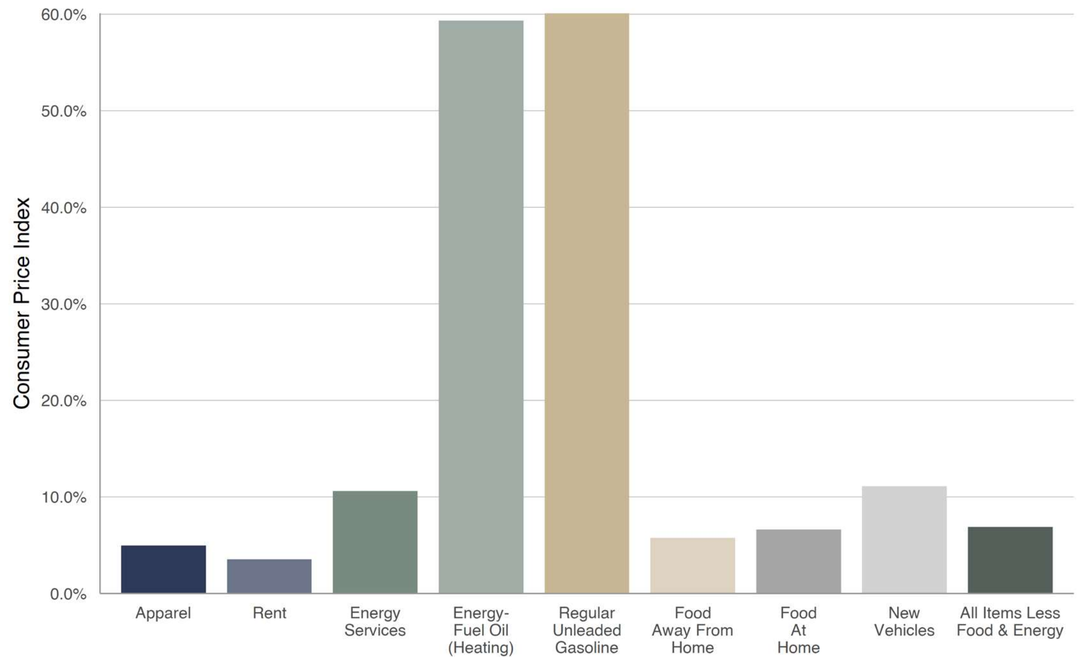


PRICES HAVE SOARED

Motor fuel and heating costs have jumped, while other categories in consumer spending have experienced more tame increases. Still, the nearly 7% jump in consumer prices (excluding food and energy) has been painful for many households. We believe many of the headwinds that spurred the jump in inflation are short-term in nature and supply-chain challenges should subside, leading to more tolerable price increases.

Figure 8:
The Impact of Inflation Is Not Felt Equally

As of 11.30.2021. All values are seasonally adjusted. SOURCE: Kovitz using data from Bloomberg Finance L.P.

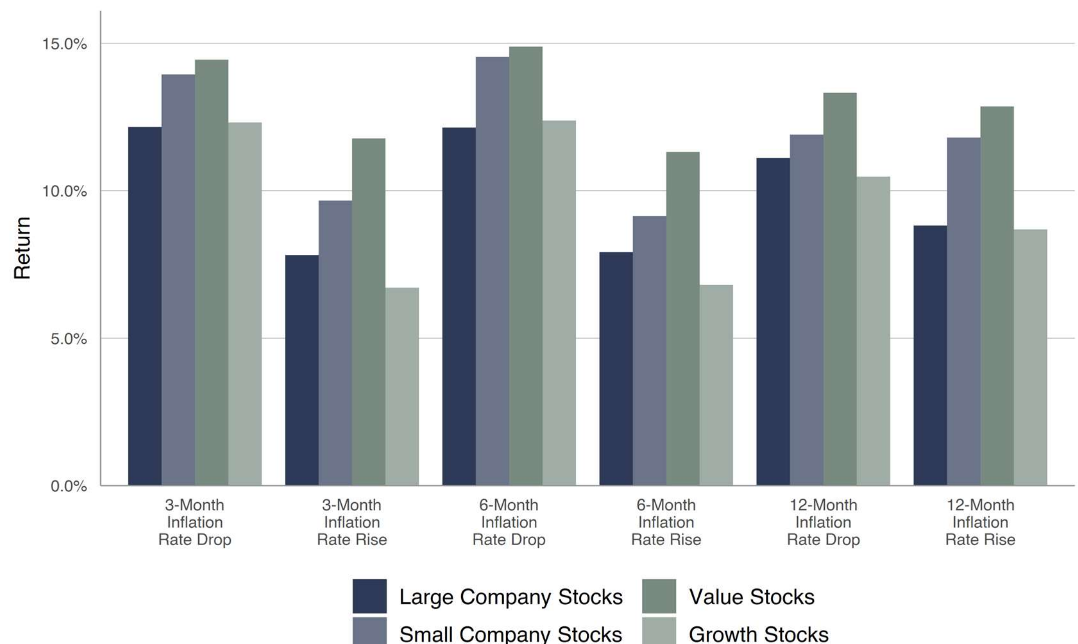


INFLATION ISN'T TERRIBLE FOR STOCKS

If the historical returns since 1927 in Figure 9 are any indication, we would argue that stocks have fared quite well while inflation is on the rise. Yes, investors do not appreciate uncertainty and spikes in consumer prices like those at the end of 2021 are harder to stomach than gradual changes in the price level. But it seems equities might even function as a quality inflation hedge, as many companies can adjust their businesses and charge customers more to account for increased costs.

Figure 9:
Equity Returns and Rising Inflation

From 12.31.1927 through 11.30.2021. Concurrent annualized 12-month returns. SOURCE: Kovitz using data from Bloomberg Finance L.P. and Professors Eugene F. Fama and Kenneth R. French

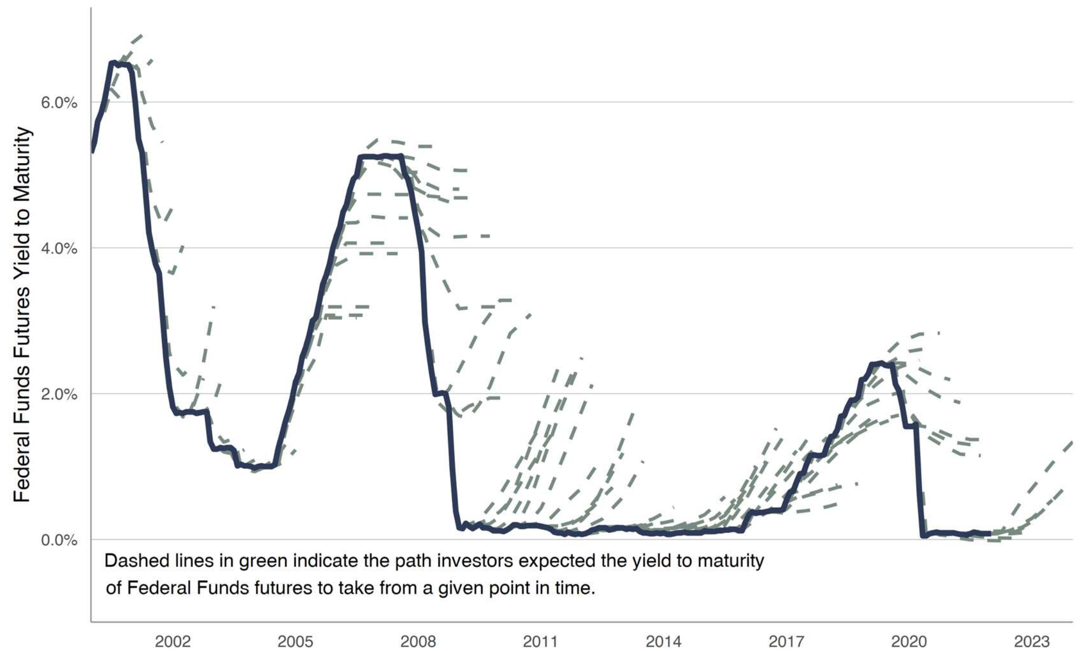


THE MARKET ISN'T ALWAYS RIGHT

Many market participants scrutinize the Fed's notes to get a jump on investment decisions, but Figure 10 shows rate change expectations do not match the experience. Minutes from the Federal Reserve's meeting in December indicated the central bank's members are ready to raise rates "sooner or at a faster pace than participants had earlier anticipated." The release on January 5 sent bond rates up and equities down, with many pundits confident that the hiking cycle would start in March.

Figure 10: Nobody Really Knows Where Rates are Heading

From 12.31.1999 through 10.31.2021. SOURCE: Kovitz using data from Bloomberg Finance L.P.



THE BEST TIME TO INVEST IS...NOW

We have long been of the mind that time in the market trumps market timing and history shows that it generally is best to let compounding commence sooner rather than later. Some may argue that it is an apples to oranges comparison, given the differences in starting and ending periods, but Figure 11 shows that average subsequent 10-year returns beginning at even the highest point each year were still very good.

Figure 11: Compounding Crushes Market Timing

Russell 3000 index total return. SOURCE: Kovitz using data from Bloomberg Finance L.P.

Russell 3000 Returns from Minimum and Maximum Points Each Year

Year	Min Date of Year	10-Year Return from Min	Year	Min Date of Year	10-Year Return from Min	Year	Max Date of Year	10-Year Return from Max	Year	Max Date of Year	10-Year Return from Max
1979	Jan 1	16.1%	1996	Jan 10	10.0%	1979	Dec 17	16.4%	1996	Dec 27	8.6%
1980	Mar 27	17.5%	1997	Apr 11	9.1%	1980	Nov 28	11.9%	1997	Oct 7	6.7%
1981	Sep 25	16.9%	1998	Oct 8	2.7%	1981	Aug 11	14.6%	1998	Dec 29	-1.2%
1982	Aug 12	18.7%	1999	Feb 9	-1.0%	1982	Dec 7	15.3%	1999	Dec 31	-0.2%
1983	Jan 3	15.7%	2000	Dec 20	2.6%	1983	Oct 10	13.7%	2000	Sep 1	-1.0%
1984	Jul 24	15.3%	2001	Sep 21	4.6%	1984	Nov 6	13.9%	2001	Jan 30	1.9%
1985	Jan 4	14.2%	2002	Oct 9	9.1%	1985	Dec 16	14.3%	2002	Mar 19	4.5%
1986	Jan 22	14.6%	2003	Mar 11	9.7%	1986	Jul 2	13.2%	2003	Dec 31	7.9%
1987	Dec 4	19.1%	2004	Aug 12	8.9%	1987	Aug 25	13.6%	2004	Dec 30	8.0%
1988	Jan 20	18.0%	2005	Apr 20	8.9%	1988	Oct 21	16.6%	2005	Dec 14	7.0%
1989	Jan 3	18.6%	2006	Jun 13	7.7%	1989	Oct 9	16.1%	2006	Dec 27	7.1%
1990	Oct 11	19.2%	2007	Mar 5	8.0%	1990	Jul 16	17.7%	2007	Oct 9	7.4%
1991	Jan 9	17.7%	2008	Nov 20	16.1%	1991	Dec 31	12.6%	2008	Jan 1	8.6%
1992	Apr 8	13.0%	2009	Mar 9	17.6%	1992	Dec 30	8.9%	2009	Dec 28	13.3%
1993	Jan 8	9.5%	2010	Jul 2	13.9%	1993	Dec 29	10.7%	2010	Dec 29	13.7%
1994	Apr 4	11.8%	2011	Oct 3	17.1%	1994	Feb 2	10.7%	2011	Apr 29	14.1%
1995	Jan 3	11.9%	**1979-2021 MEAN**		**12.5%**	1995	Dec 13	9.3%	**1979-2021 MEAN**		**10.2%**

EYES ON THE ROAD AHEAD

We hope this chart book was reassuring (except maybe the inflation graphic in Figure 8), and we have long argued that the secret to success in investing is not simply to select good stocks, but to not get scared out of them. And we offer a gentle reminder that we have wealth and asset management services available for folks that might benefit from our expertise.

As we head into 2022, we remain enthusiastic about the prospects for our Value-oriented, broadly diversified portfolios and wish our readers a grand start to 2022.

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

For more details about our wealth management and asset management services, kindly reach out to:

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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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