THE PRUDENT SPECULATOR

# Where to Invest in 2023

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Elevated inflation and rising interest rates commanded much of the attention in 2022, with proclamations from Jerome H. Powell and his colleagues at the Federal Reserve often the catalyst for volatile gyrations in the prices of stocks. Of course, those moves were generally in the southern direction over the first three quarters of the year, as the S&P 500 entered into Bear Market territory in June before hitting its low for the year on October 12.

There were no awards for the losses on Value stocks over those nine months, but inexpensive equities held up much better. The Russell 3000 Value index suffered a return of negative 18.0% while its Growth counterpart skidded 30.6%, which is in keeping with the historical evidence for Value outperformance when inflation is high, when the Fed is tightening and when interest rates are moving up.

Value stocks continued to post better relative returns in the fourth quarter, with a solid rally taking place for inexpensively priced companies, even as struggles continued for many richly priced stocks. Such was the performance dispersion that the gap between the S&P 500's Value and Growth components for 2022 ranked #2 since those indexes were created in 1996.

Of course, we are thrilled to see Value stocks get some time in the sun after a long winter, especially as they generally topped the performance of the supposedly safe fixed income indexes in 2022. We also like that stocks were able to again climb the proverbial Wall of Worry in Q4, surmounting fears of sky-high inflation, weaker-than-expected economic data, the ongoing War in eastern Europe and elevated fuel prices, to name several concerns.

Perhaps because many portfolios are heavy with Growth stocks, the nice rebound in Q4 did little to cheer the mood of investors on Main Street. Indeed, the tally of Bulls in the weekly AAII Sentiment Survey on December 21 fell to 20.3% and the number of Bears jumped to 52.3%. Considering that there are typically more optimists than pessimists, the minus 32.0% Bull-Bear spread is especially notable as one of the lowest in history. The AAII gauge is widely viewed as a contrarian measure, supporting the Wall Street maxim, "Be greedy when others are fearful and fearful when others are greedy."

To be honest, we do not understand the omnipresent negativity that seems to permeate the financial press these days. Yes, news is a business and fear sells, but the jobs picture remains robust, Q3 real (inflation-adjusted) U.S. GDP rose by 3.2% and the estimate for domestic Q4 economic growth per the Atlanta Fed on December 23rd was 3.7%. The odds of recession in 2023 are high, but the big decline in stocks witnessed in 2022 would seem to have discounted a lot of bad news that may or may not materialize.

We recognize the paper losses suffered this year are very much real, but downturns, corrections and even Bear Markets are a normal part of the investment process. On the other hand, rebounds, rallies and Bull Markets tend to occur with equal frequency. So we always remind ourselves that the secret to success in stocks is to not get scared out of them, as the magnitude of the advances has dwarfed that of the declines. Indeed, despite plenty of ugly periods, equities have enjoyed annualized returns of 9.4% (Growth) to 13.0% (Value) over the last nine-plus decades.

For the past 45 years, we have remained steadfast in our commitment to fishing in the Value pond and we see little reason to depart from our longstanding practice of owning a broadly diversified set of stocks trading for discounted relative valuations in 2023. After all, the valuation gap between Value and Growth is still very wide, with earnings multiples of the former below the long-term average and the latter priced above, despite the performance disparity in 2022.

## DON'T BOX US IN: SEVEN THEMES FOR 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.

We cannot always avoid the so-called Value traps, but we have long added qualitative reviews of our companies to the mix in an attempt 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 now in its 46th 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 seven themes and specific stocks which we think those who share our long-term view should be considering as we head into 2023 and beyond.

## QUALITY MERCHANDISE ON SALE

Given the price of the average stock has been in a Bear Market, most have endured significant selling pressure this year, often with little regard for the long-term business prospects or the caliber of the company. No doubt, there are headwinds facing much of Corporate America, but we think there are opportunities today to pick up ownership of higher-quality, well-known companies at attractive price tags.

Networking equipment titan **Cisco Systems (CSCO**), asset management giant **BlackRock (BLK)** and diversified healthcare concern **Abbott Labs (ABT)** stand out as leaders in our qualitative review process. Yes, the quality label is somewhat subjective, but each of these reasonably priced names has a long-term credit rating from Standard and Poor's of "AA-" or better and a share price down more than 20% in 2022.

## MARKED DOWN MEGACAP DARLINGS

Though **Meta Platforms (META)** is the only one of the four trading at a fire-sale price tag, the social media powerhouse, along with search-engine leader **Alphabet (GOOG)**, consumer electronics king **Apple (AAPL)** and software power **Microsoft (MSFT)** have all seen their stocks battered in 2022 (after posting enormous gains in 2020 and 2021).

Certainly, the economic slowdown, along with the massive scale of their businesses has weighed on investor psyches, but we think all four companies very much offer growth at a reasonable price, along with substantial free-cash-flow generation that allows for significant investments in new ventures, enhancements to existing products and services, and generous capital return programs.

## CONSUMERS ARE STILL HANGING IN

Inflation at its highest level in decades has been eating into discretionary income, but we think consumer spending has managed to hold up reasonably well. No doubt, an unemployment rate of 3.7%, decent wage growth and substantial savings accumulated over the last couple of years provide consumers with the means with which to keep spending. Indeed, folks have higher-than-average bank account balances and substantial home equity, plus spending had been delayed due to COVID-19 restrictions, so we think the consumer is in better shape to weather potential storms on the horizon than what many battered share prices would suggest.

Of course, equity market traders often shoot first and ask questions later, so most everything having to do with the consumer was hit hard in 2022 on the view that consumer spending will soon dry up. We respect that the near-term is very uncertain, but we think fickle investors will again return to beaten-down consumer discretionary stocks like they did after a COVID-19 crash in 2020. In our view, some of the hardest-hit stocks, like discount superstore operator **Target (TGT)**, toymaker **Hasbro (HAS)** and department-store retailer **Nordstrom (JWN)** are poised to rebound.

## THE FED PUNCHES A HOLE IN THE PUNCH BOWL

Although the estimate for real GDP growth in 2023 was pared to 0.5% in December, down from 1.2% in September, the Federal Reserve lifted its target for the Fed Funds rate by 50 basis points that month, following 75 basis point hikes at each of the June, July, September and November FOMC meetings. While the Fed slowed its pace of rate hikes at that December FOMC meeting, Jerome H. Powell & Co. are now projecting the Fed Funds rate will climb north of 5% in 2023.

The decidedly less accommodative Fed has led to sharply higher interest rates across bond land, but 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. Yes, 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.

We respect that many are worried that the Fed will not be able to engineer a so-called soft landing for the economy and that a recession will result, but 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 like **Bank of America (BAC)** and **JPMorgan Chase (JPM)** have diversified revenue streams and reach extending to corporate and municipal issuers looking to finance investment at still relatively cheap rates, given that the average Fed Funds rate dating back to the 1960s has been 4.9%.

## EV'S ARE ACCELERATING… BUT FOSSIL FUEL IS NOT GOING THE WAY OF THE DINOSAUR

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 **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 '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 are deploying the capital necessary to make it happen. Fortunately, consumers have noticed and are rewarding the likes of General Motors in such a strong way that it is moving up its '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.

Such enthusiasm also presents a nice entry point for **Albemarle (ALB)**, a power play in the EV gold rush. The lithium producer announced plans in 2022 to build a new lithium processing plant in the U.S. that will double the amount of the EV battery metal that it presently produces, while the bottom-line has been exploding.

The EV boom does not mean 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 the massive upheaval in the energy markets from the war in Ukraine and 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 **Civitas Resources (CIVI)** and **EOG Resources (EOG)**, which also boast lucrative variable dividend payouts.

## IT'S A GREAT BIG WORLD OUT THERE

While foreign market performance was healthy in 2021, it generally lagged the major domestic indexes, and returns in 2022 were not great, including in Europe. As such, we think significant opportunities exist to pick up selected and what we believe to be temporarily very depressed bargains. Diversification by geography is valuable, in our view, and fairly simple 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 sports reasonable valuation metrics.

The operations of **ManpowerGroup (MAN)** are based in the U.S., while 67% of revenue is derived from Europe. The staffing services provider has deftly navigated previous expansions and contractions across the Continent, rewarding shareholders with sizable profits and generous dividends through thick and thin.

## GOOD THINGS COME IN SMALL (AND MID) PACKAGES

Small capitalization stocks (defined by Russell/FTSE as the smallest 2,000 companies in the broad-market Russell 3000 index) of the Value variety outpaced their growth counterparts by 12 percentage points in 2022. Though small-cap Value stocks got whacked particularly hard in the Bear Market that occurred at the beginning of the pandemic, they have outpaced Growth stocks by nearly a two-to-one margin (106% to 58%) from the low point on March 23, 2020. While some of the valuation disparity has gone away thanks to strong Value stock returns, we think significant appreciation potential still exists in this corner of the stock market.

Our all-cap Value flagship strategies include small and mid-cap names, but we also offer our asset management and wealth management clients a managed account strategy that specifically caters to Small-and-Mid-Cap Dividend (SMiD) stocks. The forward P/E ratio on the SMiD portfolio is near 10, compared with 18 for the Russell 1000 index and 15 for the reasonably priced Russell 1000 Value index.

Considering our SMiD strategy, several names we highlight for 2023 and beyond are industrial battery producer **Enersys (ENS)**, railcar manufacturer **Greenbrier Cos (GBX)**, optical and photonic product supplier **Lumentum (LITE)** and homebuilder **MDC Holdings (MDC)**.

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

Those that have been reading these semi-annual Outlooks should not be surprised to see that our themes are little changed. After all, we are buying our undervalued stocks for their three-to-five-year or longer potential, with the intention of holding them through a business cycle or two. We think the market is offering those with long-term time horizons substantial opportunity as evidenced by the litany of names mentioned above, while most offer generous dividend payments, with that income helping investors better navigate the inevitable volatility of the share prices.

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 feel inclined to reiterate 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 have made money over the years from our stock holding as well as our stock picking.

## PARTNER WITH US

For over 45 years, we have collaborated with our clients in their investment decision making process as they pursue their long-term financial goals. We are committed to keeping your goals, concerns and attitude about investing at the heart of your plan. If you're ready to experience our personalized investment approach and exceptional client service, contact Jason R. Clark, CFA at 949.424.1013 or jclark@kovitz.com.

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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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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