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Noted economist John Kenneth Galbraith once proclaimed, “The only function of economic forecasting is to make astrology look respectable,” while Nobel Prize winning economist Paul Samuelson famously quipped, “The stock market has predicted nine of the last five recessions.” Is it any wonder, then, that famed physicist Neils Bohr argued, “Prediction is very difficult, especially about the future!”

Indeed, the economic stats and the performance of equities this year and last have left many scratching their heads. After all, stocks struggled mightily in 2022, even as relatively few thought an economic contraction was in the cards, given that the probability of recession, per tabulations from *Bloomberg*, started the year at 15% and did not rise to 50% until August AFTER the U.S. economy had endured two quarters of negative real (inflation-adjusted) GDP growth. Of course, the arbiter of recessions, the National Bureau of Economic Research, did not count the respective -1.6% and -0.6% real GDP growth readings in Q1/Q2 2022 as an official contraction, even though the definition of recession is accepted to be two consecutive quarters of negative growth.

Interestingly, equities bottomed as the fourth quarter began last year, right when *Bloomberg's* calculation of the odds of recession moved up to 60%. The rebound has gathered steam this year, despite the supposed experts raising their forecast of an economic contraction in the ensuing 12 months to 65%.

No doubt, the forecast for the economy is still cloudy with a chance of recession, but stocks often climb a Wall of Worry. We suppose, then, that we should not be unhappy that the Leading Economic Index (LEI) fell by 0.7% in May, with the gauge's keeper, The Conference Board, proclaiming, “The U.S. LEI has declined in each of the last fourteen months and continues to point to weaker economic activity ahead. Rising interest rates paired with persistent inflation will continue to further dampen economic activity. While we revised our Q2 GDP forecast from negative to slight growth, we project that the U.S. economy will contract over the Q3 2023 to Q1 2024 period. The recession likely will be due to continued tightness in monetary policy and lower government spending.”

Further muddying the waters, The Conference Board's latest survey of Consumer Confidence saw a big jump to 109.7 in June, up from 102.5 in May to a well-above average reading. Trying to save face, we suppose, The Conference Board argued, “Consumer confidence improved in June to its highest level since January 2022, reflecting improved current conditions and a pop in expectations...Nonetheless, the expectations gauge continued to signal consumers anticipating a recession at some point over the next 6 to 12 months.”

Obviously, time will tell whether the economy contracts, but real GDP grew 3.2% in Q3 2022, 2.6% in Q4 2022 and 2.0% in Q1 2023. Additionally, the latest projection from the Atlanta Fed is for 2.3% growth in Q2 2023 and the Federal Reserve is predicting 1.0% growth for 2023. And speaking of the Fed, we respect that there is still great concern about the fight against inflation, despite the core Personal Consumption Expenditure index for May and both the headline and core Consumer Price indexes for June falling to lower-than-expected readings, with the most recent forecasts from the FOMC suggesting we should expect two more hikes by year end before interest rates recede next year.



We will leave the economic fretting to others as we note that most who expect a recession believe it will be mild, while we think nominal GDP will continue to expand. Since corporate profits are measured in nominal (actual) and not real (inflation-adjusted) dollars, we are not surprised that the latest estimates from Standard & Poor's itself for bottom-up operating EPS for the S&P 500 stand at \$216.05 this year and \$242.44 in 2024, compared to \$196.95 in 2022.

With the Fed seemingly near the end of its tightening cycle and valuations for TPS Portfolio (forward P/E ratio of 13 and dividend yield of 2.9%) still very attractive, we retain our long-term optimism, especially as the last nine months affirm Lao Tzu's assertion, "If you do not change direction, you may end up where you are heading."

#### MINTY FRESH BREADTH SINCE THE END OF MAY

After Tech stocks took a drubbing last year—the S&P 500 Information Technology sector index fell nearly 30%—the group staged a remarkable comeback in the first half of 2023. The year's surge, powered by enthusiasm for artificial intelligence, added an enormous \$3.648 trillion to the market capitalizations of the top ten stocks in the S&P 500 index over the first five months. Through the end of May, Apple tacked on \$720 billion of market value, while Microsoft contributed another \$654 billion. Nvidia joined the trillion dollar club becoming the the fifth-largest member of the S&P 500 as its market value jumped more than \$600 billion in the first five months of the year.

We highlighted **Apple (AAPL)** and **Microsoft (MSFT)**, as well as other year-to-date giant-cap stellar performers **Alphabet (GOOG)** and **Meta Platforms (META)** as MARKED DOWN MEGACAP DARLINGS in our *2023 Market Outlook*, but their massive contributions to the S&P 500's handsome gain through May 31 masked the lag in performance by the average stock in the index, which lost 0.1% including dividends over the first five months. That chasm offered another reminder that it remains a market of stocks and not merely a stock market. Going forward, we think the wide dispersion in returns creates plenty of opportunity, especially in the Value space.

Happily, investors appreciated some of those opportunities in June, with a significant broadening of enthusiasm for equities taking hold. In fact, the Russell 2000 small-cap index jumped 8.1% in June alone, while the Russell 3000 Value index rebounded 6.7%, with those gains continuing into the second week of July.

We believe Value's time in the sun is still in the early hours. After all, Value stocks historically have outperformed Growth over the long-term, but their valuation metrics today, such as Price to Book Value and Price to Earnings, are still in line with or even below the long-term averages dating back to the mid-1990s. This is in sharp contrast to Growth stocks, which are trading well above their historical norms.

#### 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 47th 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 the second half of 2023 and beyond.

## A RUN ON THE BANKS BY SHAREHOLDERS, BUT NOT BY DEPOSITORS

Hard to argue that there weren't bank-stock headwinds in the first half of 2023, given the lightning-quick collapse of two prominent institutions in Silicon Valley Bank and Signature Bank after uninsured depositors fled en masse, followed by the demise of European financial behemoth Credit Suisse and prominent California lender First Republic.

However, a threatened systemwide mass exodus of depositors has failed to materialize, while 23 of the nation's biggest banks just passed the Federal Reserve's latest round of Stress Tests, with Fed Vice Chair Michael S. Barr stating, "Today's results confirm that the banking system remains strong and resilient."

Certainly, concerns remain about net interest margins, commercial real estate defaults and shrinking loan volumes, but the punishment inflicted on bank stocks has been excessive, in our view.

Regional banks offer superb risk-reward profiles these days with rich dividend yields. Highly regarded **PNC Financial (PNC)** has historically managed risks well and presently boasts a broadly diversified loan book, solid capital ratios and strong credit quality. On the riskier end of the spectrum, a typically more-volatile **Bank OZK (OZK)** offers unique exposure to commercial and industrial lending, and has historically produced above average net interest margin while experiencing mild loan losses relative to peers.

A pair of Ohio-based banks also are attractive. **Fifth Third Bancorp (FITB)** has endeavored to de-risk the loan book over the past decade, while deposits held steady in Q1 and the company had no securities as held-to-maturity going into the deposit crisis, meaning no "hidden" losses on the balance sheet. **KeyCorp (KEY)** also resisted the temptation to load up its balance sheet with held-to-maturity assets and boasts one of the largest investment banking businesses amongst peers of its size that should see improvement as capital formation activity normalizes higher.

Looking at bigger banks, it's hard not to like **JPMorgan Chase (JPM)**, as its fortress balance sheet provides a stable keel to go along with an ability to generate profits in varied environments. A statistically deeper bargain, trading at a huge discount to tangible book value, we are liking the turnaround efforts underway at globally diverse **Citigroup (C)** under new CEO Jane Fraser. We also think **Goldman Sachs (GS)** stands out with its well-known financial prowess that has helped maintain immense profitability despite weathering multiple strategic shifts in recent years.

## HEALTH CARE (TEMPORARILY) IN THE SICK BAY

Whether it has been a shift in investor attention away from safer stocks, worries about government price controls or question marks about medical cost ratios, it has been tough sledding in 2023 for many stocks in the Health Care sector.

We think the disinterest in pharmaceutical makers and health management companies is short-sighted, especially as long-term demographic trends – folks have greater access to life-saving, life-lengthening and life-enhancing therapeutics and treatments – argue that Health Care is a growth area.

True, more modest growth potential today might suggest lower valuation metrics are warranted than in years past. However, in an environment where Utility stocks trade for P/E ratios in the mid-teens, we believe that Big Pharma stocks like **Pfizer (PFE)** and **Bristol-Myers Squibb (BMY)** as well as biotech giants **Amgen (AMGN)** and **Gilead Sciences (GILD)**, all of which boast Utility-like yields, deserve significantly higher price tags.

Looking at managed-care, industry giant UnitedHealth's disclosure that costs were on the rise due to an increase in pandemic-delayed surgeries among older adults has created a great entry point in stocks like **Elevance Health (ELV)** and **CVS Health (CVS)**, both of which trade for significantly lower multiples of earnings.

Interestingly, Elevance recently indicated that medical care trends were in line with the company's expectation, while the



Anthem BlueCross and BlueShield and Wellpoint operator reaffirmed its solid 2023 EPS growth outlook. Meanwhile, CVS, with its Health Services, Health Care Benefits and Pharmacy & Consumer Wellness business segments, is trading for just 8 times forward earnings expectations, while boasting a dividend yield more than twice that of the S&P 500.

### SHOOT FIRST AND ASK QUESTIONS LATER

With conventional wisdom suggesting that a possible recession and higher interest rates are somehow bad for equities, despite significant historical evidence that we have repeatedly shown to the contrary, many stocks have been punished for sins that they may not ever commit or for modest transgressions that might merit a slap on the wrist rather than a lengthy prison sentence.

As such, we think that with a soft-landing on the table for the economy, or at least a very modest recession if there is a contraction, battered and bruised stocks like oil refiner **HF Sinclair (DINO)**, athletic apparel and footwear retailer **Foot Locker (FL)**, protein producer **Tyson Foods (TSN)** and engineered products used in bedding and furniture maker **Leggett & Platt (LEG)** should bounce back from their first-half 2023 declines.

We also note that the Fed Fund futures market is suggesting that Jerome H. Powell & Co. have only one more rate hike to go, which might suggest a change in sentiment toward interest sensitive stocks like wireless communications and broadcast tower REIT **American Tower (AMT)**, medical lab and office REIT **Alexandria Real Estate (ARE)**, life insurer **MetLife (MET)** and telecom titan **Verizon Communications (VZ)**.

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

Significant hurdles remain for electric vehicles before the transition can be considered a success, but adoption of the technology is picking up and manufacturers like **General Motors (GM)** and **Volkswagen (VWAPY)** have been working on paths to full EV product lines for most of their personal vehicle sub-brands. As range has expanded and charging stations have become easier to find, consumers have snapped up EVs at a quick pace, no doubt helped by generous (and recently extended) incentives offered by manufacturers, governments and local utilities.

As the citizens of Texas learned during the deep freeze in February 2021, the EV transition is only part of the electrification equation, and supply-demand issues can arise as a result of other factors. Worries about the reliability of the nation's grid system, which is not unified at present, is a source of hesitancy and is sure to slow the adoption of electrified technologies. Upgrades are likely to include products from the likes of **EnerSys (ENS)**, a firm specializing in the development and manufacture of stored energy solutions (usually batteries) for telecom, utility, medical, aerospace and defense customers. Not only will ENS products serve as backups and storage solutions, the Grid-Interactive Systems unit offers customers the capability to integrate renewable energy sources with fossil fuel energy generation.

Also worth mentioning is **Albemarle (ALB)**, which has been on a tear since we first recommended the lithium miner in March 2019. The figurative deep breath in Q1 numbers offered another good entry point for those in search of EV-related exposure via a miner with a growing demand base. Politics will play a part in ALB's future, especially as the company earns almost 90% of its revenue abroad and has significant interests in Chile. We suspect ultimate interests are aligned - ALB wants to get the minerals out of the ground and governments are happy to have the (enormous) revenue streams.

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 should support energy prices for the foreseeable future.

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.



Finally, **TotalEnergies (TTE)** has done well using fossil-fuel cash flows to invest in renewable energy sources, while we also appreciate the approach to capital deployment management at **Exxon Mobil (XOM)** is taking to balance reducing debt, making acquisitions, investing in new projects and returning capital to shareholders.

#### INTELLIGENT WAYS TO PLAY A.I.

The first taste of A.I. came in the form of ChatGPT, which took off earlier this year, and the technology caused a stampede toward stocks heavily or tangentially related to it. Nvidia, a long-ago holding of ours which remains (disappointingly) planted in Growth territory, was the most visible beneficiary of the rush. Even though a good chunk of fanfare on Nvidia is for its manufacturing ability of chips that power some of the most promising A.I. technologies, we have long maintained exposure to IT breakthroughs in Tech via companies like **Microsoft (MSFT)**, **Alphabet (GOOG)** and **Meta Platforms (META)**. Smaller-company names like optical and photonic equipment provider **Lumentum (LITE)**, power management concern **Eaton (ETN)** and data center REIT **Digital Realty (DLR)** also stand to benefit from widespread A.I. adoption.

We found it strange that the interest in A.I.-related companies left chipmaking giant **Intel (INTC)** behind, despite the company having products available that support A.I. products. In addition, Intel's roadmap includes new chips specifically designed for A.I. and Nvidia has publicly stated that Intel is in the running to produce future generations of Nvidia graphics chips (GPU), which would diversify the company's manufacturing exposure and improve GPU supplies. And speaking of manufacturing, we also like semiconductor capital equipment makers **Lam Research (LRCX)** and **Kulicke & Soffa (KLIC)**.

With A.I. technology in its infancy, we think soaring Tech share prices should not deter long-term investors from adding Tech companies to their broadly diversified portfolios. Monetization of the technology with consistency will come down the road and there are likely to be bumps along the way, resulting in a strong preference to spreading the exposure over several stocks, rather than larger stakes in one or two.

#### IT'S A GREAT BIG WORLD OUT THERE

Foreign market performance outpaced the Russell 3000 Value index in the first half of this year, propelled in large part by strong advances for companies on the European continent, again illustrating the value in investing with a global consideration. Even though we hold plenty of U.S.-based companies that earn large portions of their revenue abroad, we continue to find value in holding a handful of companies that are domiciled around the globe (and have U.S.-traded receipts – ADRs).

We take advantage of this ability with our ownership in a variety of foreign companies, from German parcel carrier **DHL Group (DHLGY)**, which derives 75% of revenue outside the Americas, to French drugmaker **Sanofi (SNY)**, which earns 60% of its revenue abroad, has a robust therapeutics pipeline and sports reasonable valuation metrics, to Canadian crop input and service provider **Nutrien (NTR)**, which is impacted by developments in the global commodities markets.

The operations of **ManpowerGroup (MAN)** are based in the U.S., while 64% 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. **Cummins (CMI)** a global power leader that produces diesel, natural gas, electric and hybrid powertrains and powertrain-related components, generates 43% of its revenue outside the U.S. and business around the world has been stronger this year than expected, while the dividend was just boosted by 7%.

Rapidly rising interest rates in the U.S. have caused ripple effects around the world and we think weakening in the U.S. dollar makes foreign revenue streams even more valuable in a broadly diversified portfolio.

#### 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 the latter has won the performance derby so far in 2023. 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 wide margin (more than 30 percentage



points as of early July) 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 11, compared with 21 for the Russell 1000 index and 16 for the reasonably priced Russell 1000 Value index.

Considering our SMiD strategy, several names we highlight for the rest of 2023 and beyond are logistic services provider **World Kinect (WKC)**, food producer **Fresh Del Monte (FDP)**, metal machinery controller maker **Hurco Companies (HURC)**, regional bank **Western Alliance (WAL)**, medical device maker **Utah Medical Products (UTMD)** and furniture maker **Ethan Allen (ETD)**.

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.

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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 portfolios are monthly averages of the two returns.

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