the Prudent Speculator
IN PARTNERSHIP WITH KOVITZ

# 2024 Visual Guide to the Markets

**JANUARY 2024**

John Buckingham
Principal
Portfolio Manager

Jason R. Clark, CFA
Principal
Portfolio Manager

Christopher Quigley, CFA
Senior Research
Analyst

Zack Tart
Portfolio & Research
Associate

## KEY TAKEAWAYS

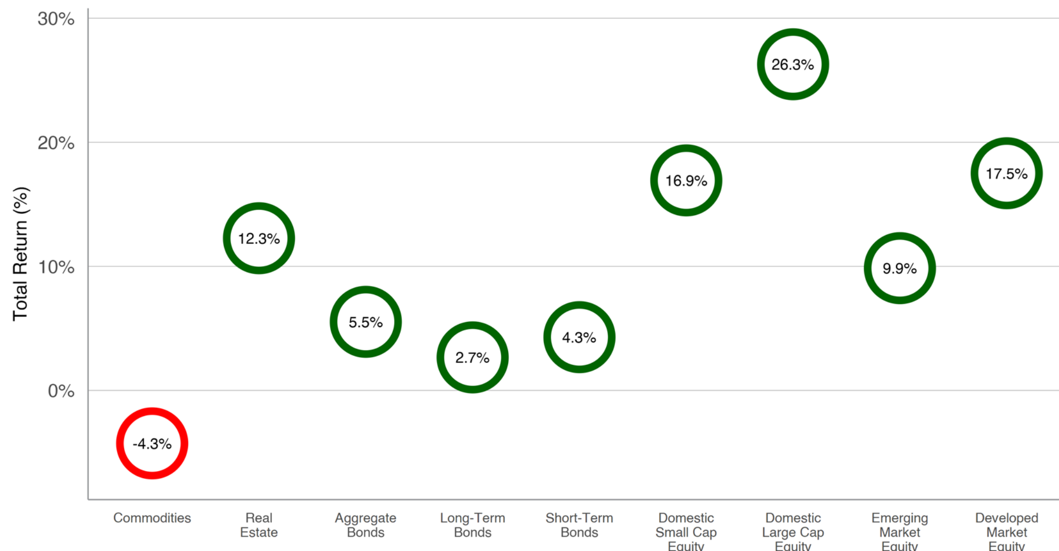
- **Sideline Risk**: Headlines that stoked fear in 2023 have yet to fully recede, causing some folks to remain in a precarious position: out of the market.
- **Valuations**: Value and Small-Company stocks continue to sport inexpensive valuations, offering opportunity for long-term investors to buy stocks 'on sale'.
- **More Ups than Downs**: We see no reason to temper our enthusiasm for our broadly diversified portfolios of undervalued stocks

Inflation, rising interest rates and economic worries were top of mind heading into 2023, causing many folks to remain on the market's sidelines. The efforts to kneecap inflation by the Federal Reserve seem to have worked, suggesting that a fabled "Soft Landing" has moved from improbable to possible. As pricing pressures receded, the Fed slowed the pace of rate hikes, with the Fed Funds rate eventually reaching 5.5% in July and holding steady since.

Unfortunately for those parked in cash, the worries had a real cost as equity markets turned in a solid year. The S&P 500 rose 26.3% including dividends, while Small Company stocks rose 16.9%. Global returns were also respectable. After a drubbing in 2022, bonds posted modest gains, while public real estate's double-digit tally was more than double the long-term average.

Of course, it was not all smooth sailing in 2023. There were two 10% corrections, while the average stock was mired in the red for much of the year before rallying post-Halloween and the sizable returns of the cap-weighted market indexes were driven by huge gains in just a handful of mega-cap names. However, we again saw that the secret to investment success in stocks is not to get scared out of them.

### Figure 1: Year-to-Date Asset Class Returns




From 12.31.2022 through 12.31.2023. Green (red) rings indicate positive (negative) performance. Total returns in percent are presented in black text. Index definitions are available at the end of this Insight. SOURCE: Kovitz using data from Bloomberg Finance L.P.

## QUARTERLY RETURNS FLUCTUATE

The worries that plagued portfolios in 2021 and 2022 have started to fade away, and the rally in Q4 offered another reminder that it's hard to get market timing right. There are plenty of reasons to be optimistic about long-term investment return potential and the overall trajectory of the economy, but we have noticed the reasons to buy stocks aren't trumpeted as loudly as the reasons to sell them.

### Figure 2: Last Five Years of Quarterly Asset Class Returns

| | Commodities | | | | Real Estate | | | | Aggregate Bonds | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 |
| 2019 | 15 | -1 | -4 | 8 | 16 | 1 | 7 | -1 | 3 | 3 | 2 | 0 |
| 2020 | -42 | 10 | 5 | 14 | -27 | 11 | 1 | 11 | 3 | 3 | 1 | 1 |
| 2021 | 14 | 16 | 5 | 2 | 8 | 12 | 1 | 16 | -3 | 2 | 0 | 0 |
| 2022 | 33 | 2 | -10 | 3 | -4 | -17 | -10 | 5 | -6 | -5 | -5 | 2 |
| 2023 | -5 | -3 | 16 | -11 | 2 | 2 | -7 | 16 | 3 | -1 | -3 | 7 |

| | Long-Term Bonds | | | | Short-Term Bonds | | | | Domestic Small Cap Equity | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 |
| 2019 | 5 | 6 | 8 | -4 | 1 | 1 | 1 | 1 | 15 | 2 | -2 | 10 |
| 2020 | 21 | 0 | 0 | -3 | 3 | 0 | 0 | 0 | -31 | 25 | 5 | 31 |
| 2021 | -14 | 7 | 0 | 4 | 0 | 0 | 0 | -1 | 13 | 4 | -4 | 2 |
| 2022 | -11 | -13 | -10 | -1 | -3 | -1 | -2 | 1 | -8 | -17 | -2 | 6 |
| 2023 | 7 | -2 | -13 | 13 | 2 | -1 | 1 | 3 | 3 | 5 | -5 | 14 |

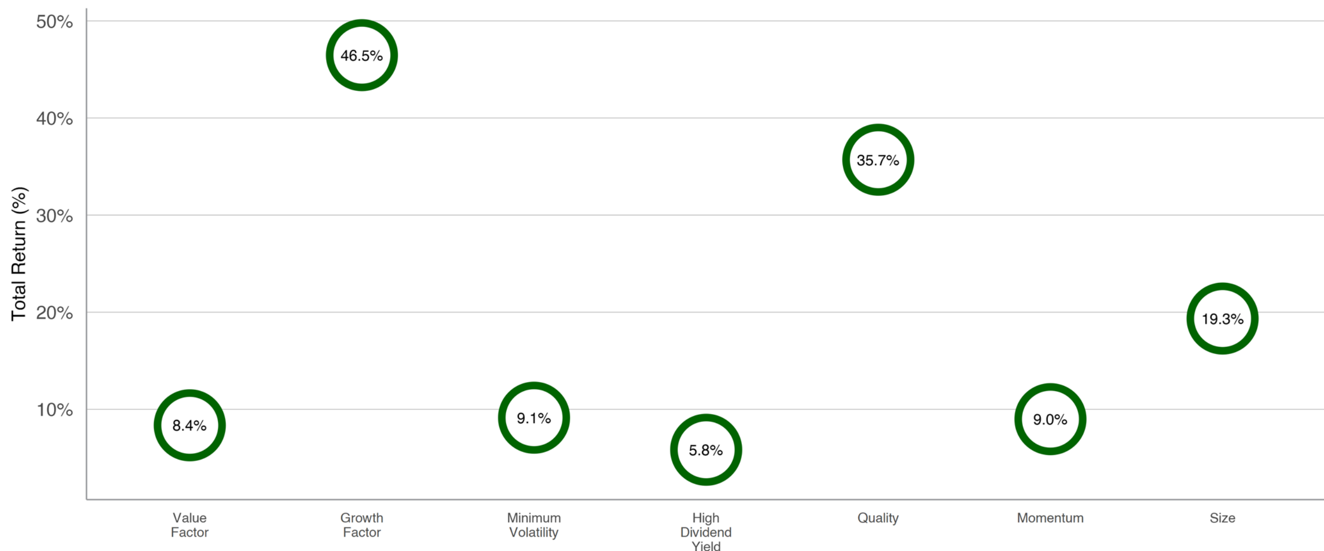
| | Domestic Large Cap Equity | | | | Emerging Market Equity | | | | Developed Market Equity | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 |
| 2019 | 14 | 4 | 2 | 9 | 10 | 1 | -4 | 12 | 10 | 4 | -1 | 8 |
| 2020 | -20 | 21 | 9 | 12 | -24 | 18 | 10 | 20 | -23 | 15 | 5 | 16 |
| 2021 | 6 | 9 | 1 | 11 | 2 | 5 | -8 | -1 | 3 | 5 | 0 | 3 |
| 2022 | -5 | -16 | -5 | 8 | -7 | -11 | -12 | 10 | -6 | -15 | -9 | 17 |
| 2023 | 7 | 9 | -3 | 12 | 4 | 1 | -3 | 8 | 8 | 3 | -4 | 10 |

From 12.31.2018 through 12.31.2023. Green (red) rectangles indicate positive (negative) performance. Total returns in percent are presented in white text for each period. Index definitions are available at the end of this Insight. SOURCE: Kovitz using data from Bloomberg Finance L.P.

## FACTOR PERFORMANCE

Value stocks struggled to keep up with Growth stocks in 2023, a reversal from Value's large outperformance in 2022, evening out the two-year performance derby for the pair. Quality and Size also were factors that turned in a solid year, while High-Yield, Minimum Volatility and Momentum factors saw subdued returns. Having managed Value-oriented portfolios since 1977 with success, we think investors who make factor-based investments are better suited to longer holding periods.

### Figure 3: MSCI 2023 Factor Returns

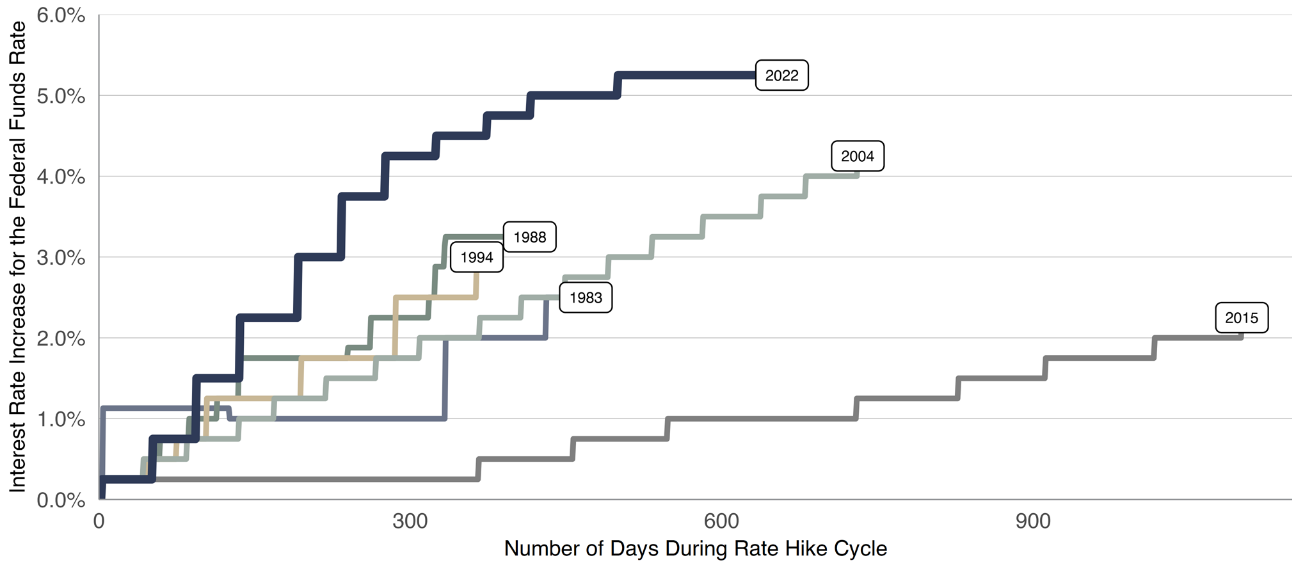



From 12.31.2022 through 12.31.2023. Green (red) rings indicate positive (negative) performance. Total returns in percent are presented in black text. Index definitions are available at the end of this Insight. SOURCE: Kovitz using data from Bloomberg Finance L.P.

## WELL, THAT ESCALATED QUICKLY

In comparison to rate-hike cycles since 1983, the Federal Reserve moved at breakneck speed in 2022/2023. While 2015's cycle took more than a thousand calendar days, the latest hike cycle rose 5.25% in just 16 months. With the hikes largely doing the trick in the Federal Reserve's eyes, rates have plateaued since July and the FOMC's "dot plot" predicts (for whatever that is worth) a pullback in rates beginning in 2024, eventually reaching a long-term target around 2.5%.

### Figure 4: The Fed Pauses Its Rapid Rate Hikes

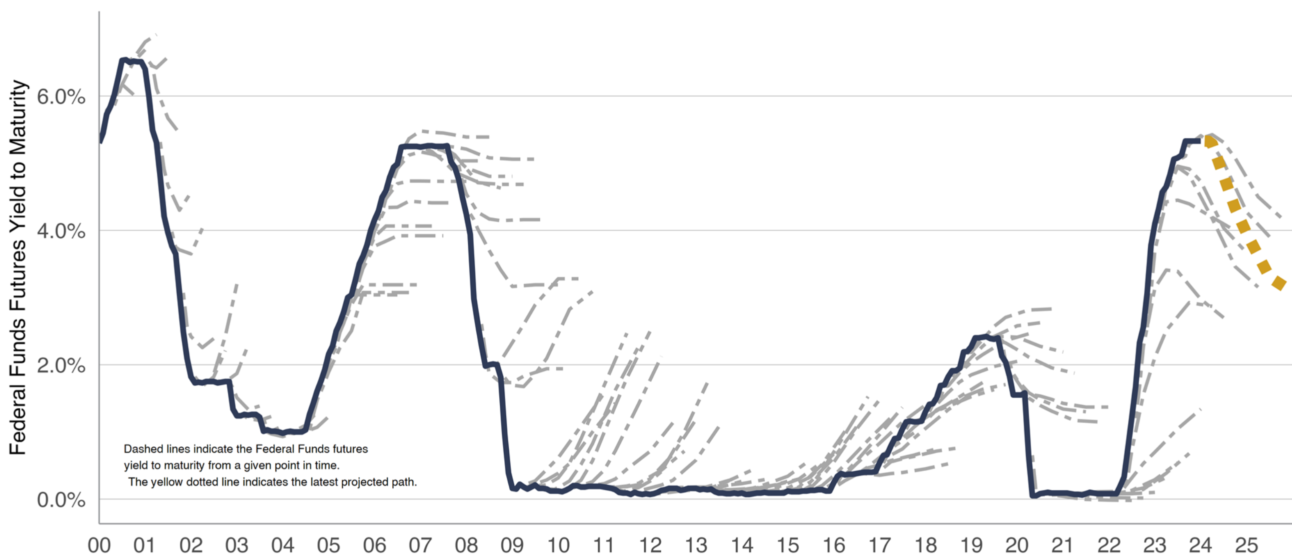



From 03.31.1983 through 12.31.2023. SOURCE: Kovitz using data from Bloomberg Finance L.P., Federal Reserve Board of Governors, Federal Reserve Bank of St. Louis and NBER.

## IT'S HARD TO PREDICT THE FUTURE

We amended the word predicts in quotes above because it's difficult to predict the future, especially so when it comes to interest rates. In Figure 5, we plot the Federal Funds Rate and point-in-time futures trajectories. While a significant rate retreat may happen over the next few years, there were only a handful of instances the futures markets accurately predicted the path of rates. Importantly, there is real money in the futures market, meaning it's not a willy-nilly poll of a handful of folks.

### Figure 5: A Tough Time Predicting the Rate Trajectory

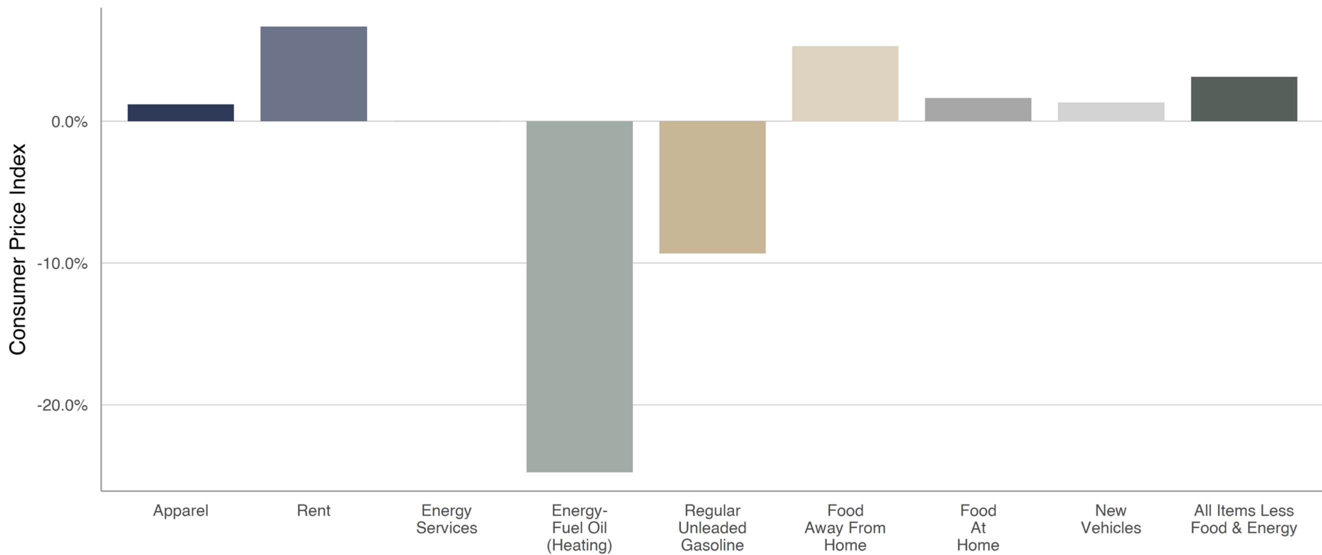



From 12.30.1999 through 12.31.2023. SOURCE: Kovitz using data from Bloomberg Finance L.P.

## LIVING HAS BECOME SLIGHTLY LESS EXPENSIVE

Inflation, inflation, inflation. From the dinner table to the car lot, the rising cost of living dominated conversation for nearly two years. Although slower-moving components like rent have continued to climb, energy and fuel prices have made substantial retreats, while the pace of price hikes for apparel, new auto and food prices has dramatically slowed. We suspect the relief is welcomed.

### Figure 6: Inflation Remains Elevated Across the Board

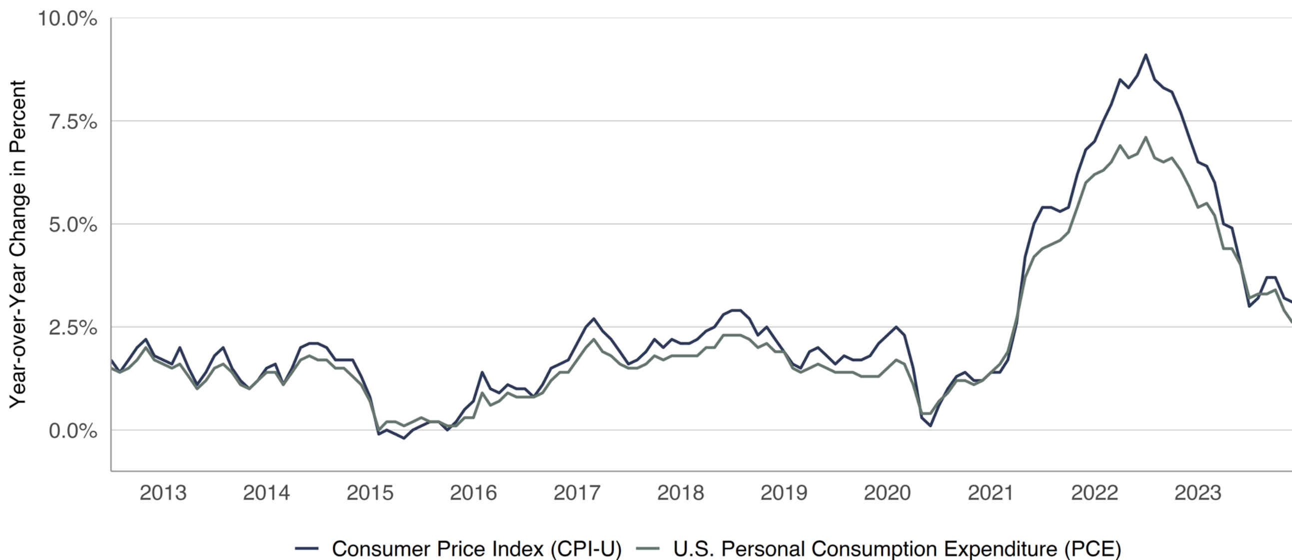



As of 12.31.2023. SOURCE: Kovitz using data from Bloomberg Finance L.P.

## INFLATION, BUT DIFFERENT

The Consumer Price Index (CPI-U) and U.S. Personal Consumption Expenditure Index (PCE) are commonly used to measure inflation. Both track a basket of goods, but vary in formula, weight, scope and other factors. CPI-U uses household data, while PCE uses business data. CPI only considers out-of-pocket spending, and PCE includes indirect expenditures. Methodology differences frequently result in different inflation figures. We monitor both but prefer to use PCE, as does the Federal Reserve.

### Figure 7: Inflation Barometers Vary, but Tell the Same Story

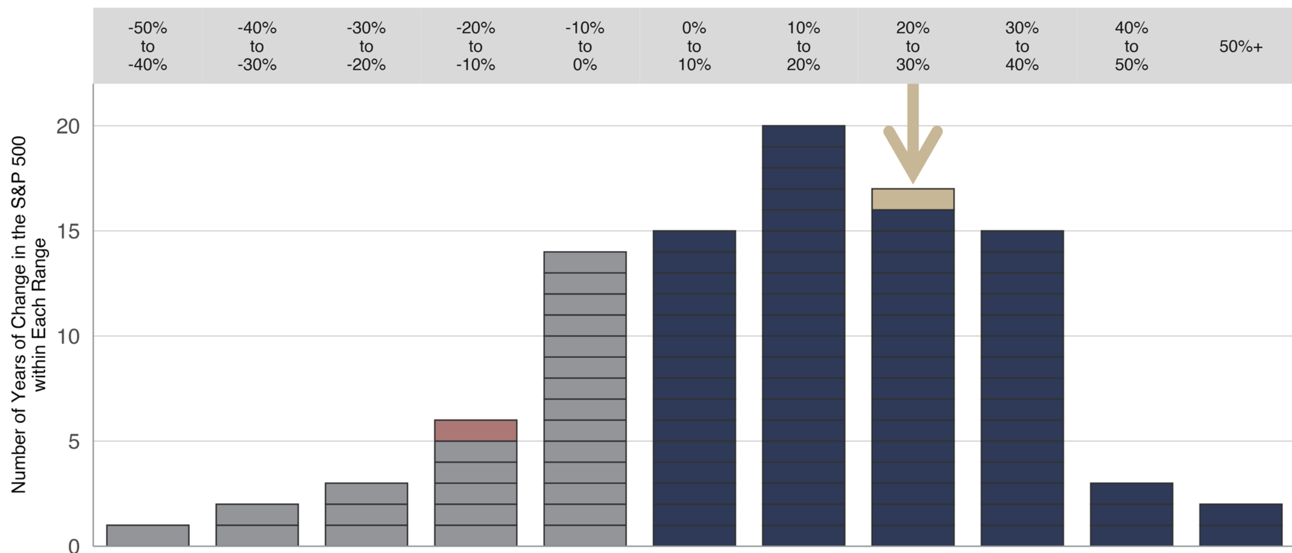



From 12.31.1925 through 12.31.2022. SOURCE: Kovitz using data from Bloomberg Finance L.P.

## YOU ARE HERE: EQUITIES

Stock returns made a strong resurgence last year (following a dismal 2022) and offered another reminder that the hardest part of market timing is getting the timing right. As the year's return shows, the recession that was loudly predicted to arrive in 2023 did not in fact arrive, and the Bloomberg Recession Probability index fell from a high of 68% in January 2023 to 50% at the end of December.

### Figure 8: The S&P 500 Bounced Back

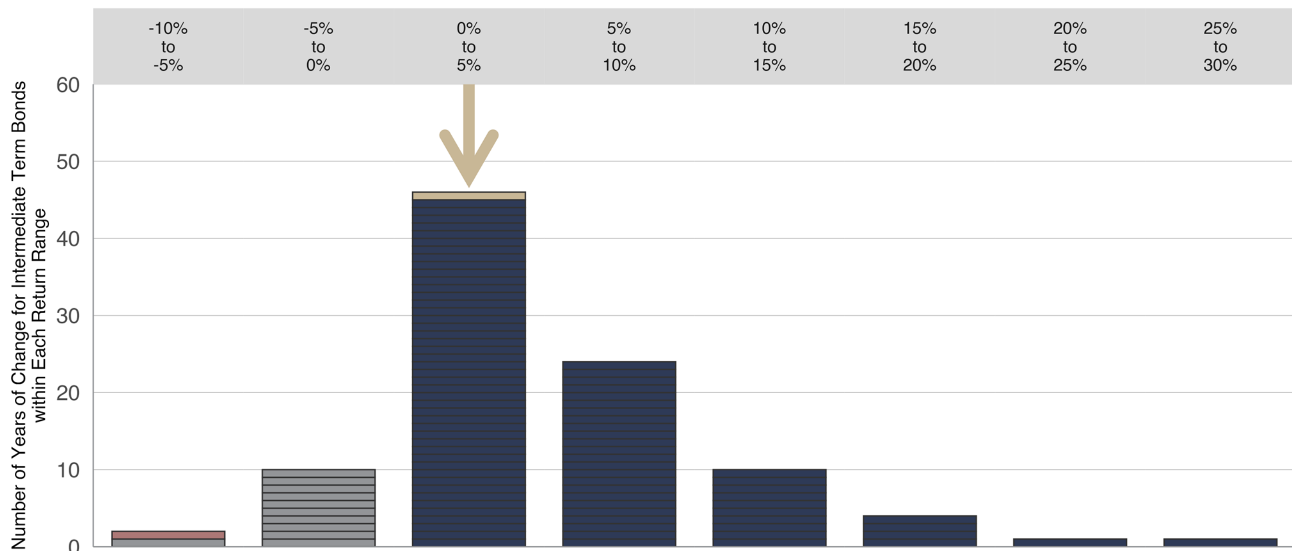



From 12.31.1925 through 12.31.2023. Red box indicates 2022's return. Gold box indicates 2023's return. SOURCE: Kovitz using data from Morningstar

## YOU ARE HERE: BONDS

On the bond side of the investment world, a series of swift rate hikes by the Federal Reserve sent bond prices plunging in 2022 (red box), with the mathematical certainty that rising interest rates send bond prices falling on full display. Figure 9 shows there was a modest recovery by intermediate-term bonds (average maturity around 5 years), and certainly no records were set by the barely positive performance figures.

### Figure 9: Bonds Bounced Modestly, Too

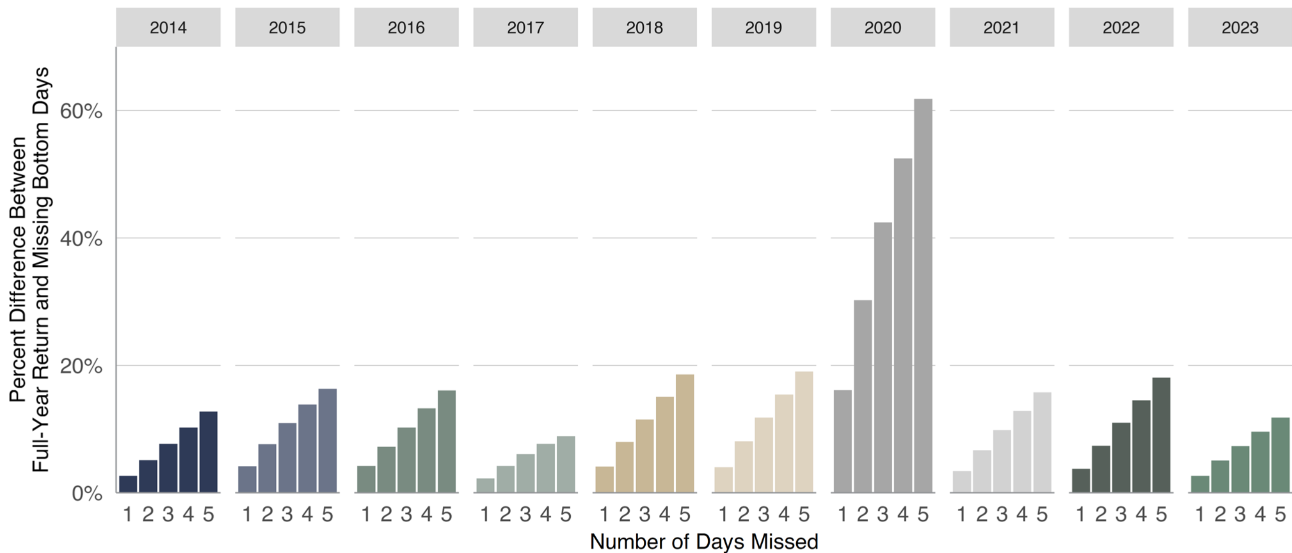



From 12.31.1925 through 12.31.2023. Red box indicates 2022's return. Gold box indicates 2023's return. IA SBBI U.S. Intermediate-Term Government Bond Index. SOURCE: Kovitz using data from Morningstar and Bloomberg Finance L.P.

## AVOIDING WHAT, EXACTLY?

The art of portfolio building usually includes some downside aversion. Most often, this is accomplished by making allocations to different asset classes and is the 'first line of defense' for the rainy days that inevitably come. What would happen if we missed those sharply negative days completely? Figure 10 shows it would be a lucrative strategy. Including the wild ride that was 2020, the average annual performance improvement from missing the bottom five days is 19.9% over the last decade.

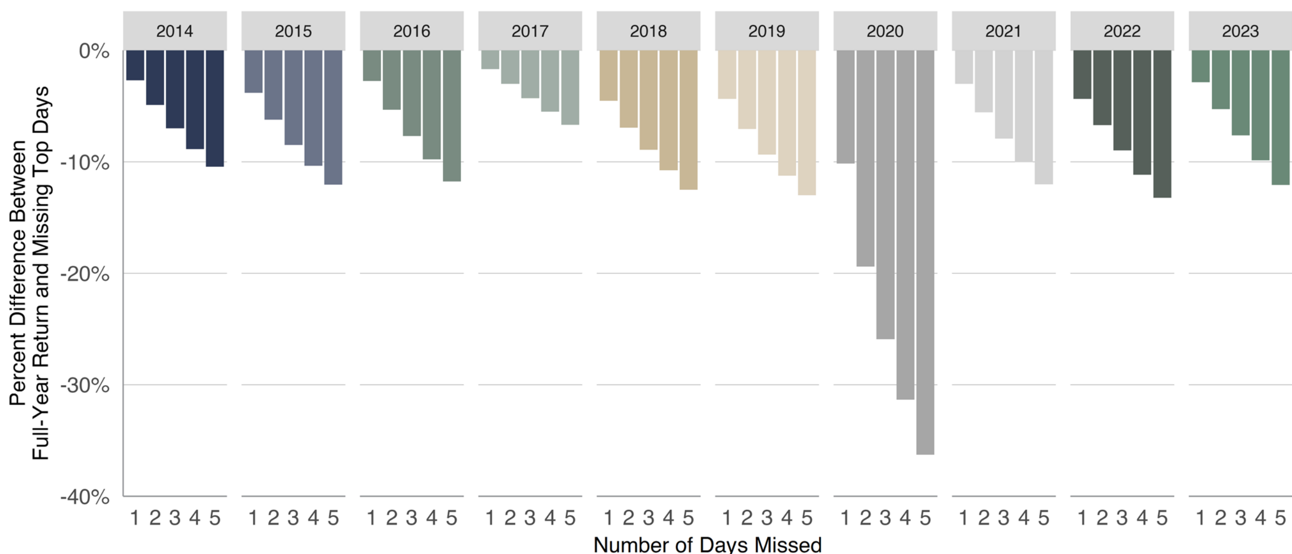
### Figure 10: Missing the Worst Days Is a Winning Strategy




From 12.31.2013 through 12.31.2023. A number of most-negative stock market performance days were skipped each year. After excluding the specified number of worst days, the geometric average return was calculated and subtracted from the S&P 500's full-year total return. SOURCE: Kovitz using data from Bloomberg Finance L.P.

With volatile up-and-down days often occurring in clumps, the strategy would almost certainly miss the five best days, too. Figure 11 shows the impact, averaging an annual 14.0% reduction in returns over the past ten years. The strategy's 6% gap narrows further when we consider that a 14.0% loss (by not experiencing the up days) and a 19.9% gain (by skipping the down days) ends up adding *just* 3.1% to the 12.0% S&P 500 annualized return. There are taxes and transaction costs to consider, too, lest we forget to include the cost of the crystal ball algorithm to perfectly time the top and bottom days each year.

### Figure 11: But Missing the Best Days Erases Most of the Gains

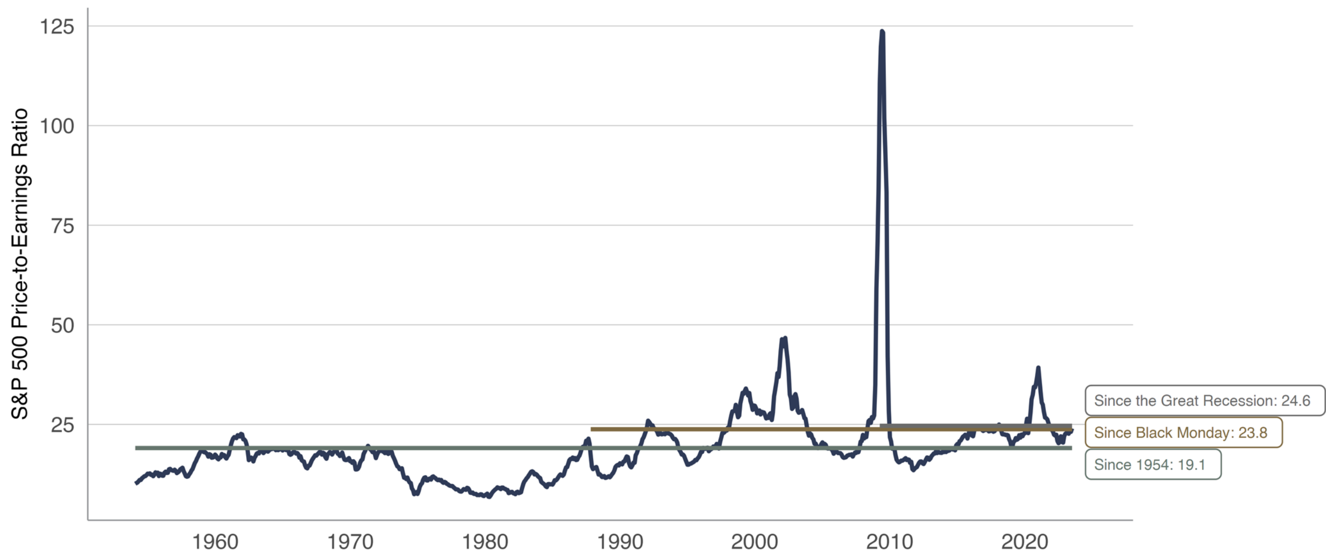



From 12.31.2013 through 12.31.2023. A number of most-positive stock market performance days were skipped each year. After excluding the specified number of best days, the geometric average return was calculated and subtracted from the S&P 500's full-year total return. SOURCE: Kovitz using data from Bloomberg Finance L.P.

## AGGREGATE VALUATIONS ARE VOLATILE

Since 1954, the long-term price-to-earnings ratio average for the S&P 500 has hovered around 19 times (green line), while the ratio's recent averages have been quite a bit higher (Black Monday in 1987 in gold and the low point during Great Recession in grey). The swings in the series can be distilled into two factors: (1) the S&P 500's price level (numerator), which is currently around 4800 and (2) the S&P 500's trailing earnings per share (denominator).

### Figure 12: The S&P 500 Index's P/E Ratio Fluctuates A Lot

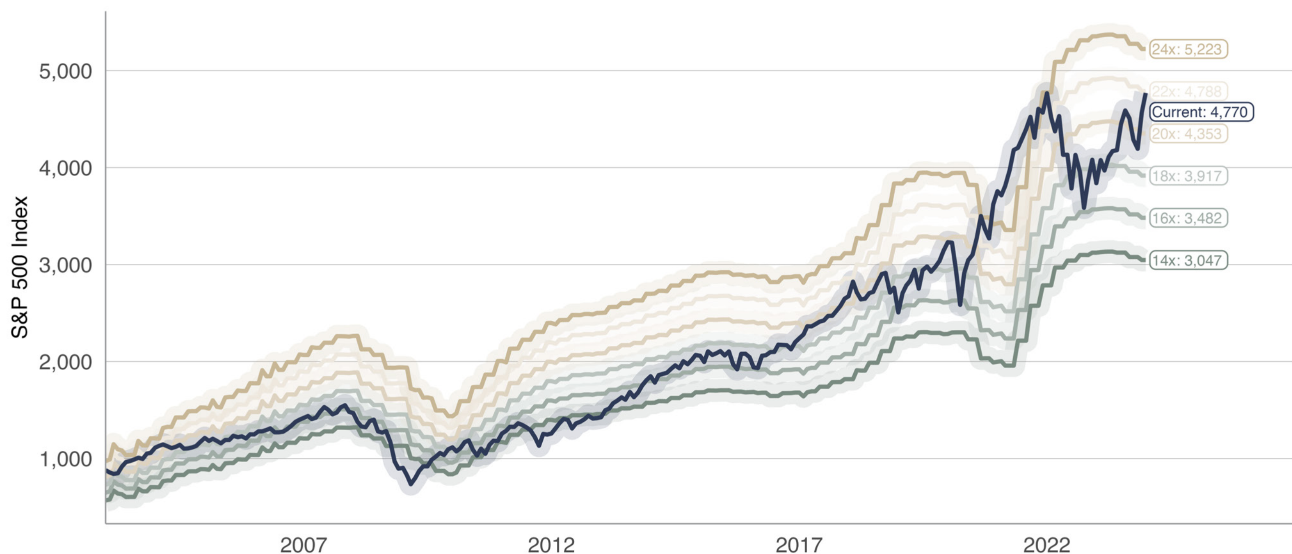



From 12.31.1953 through 06.30.2023. Trailing 12-month price-to-earnings ratio. Black Monday occurred on October 19, 1987. The S&P 500's low during the Great Recession was on March 3, 2009 and is the starting point for the average in this chart. SOURCE: Kovitz using data from Professor Robert J. Shiller

## MULTIPLES CAN CHANGE TOO

Investors love to see growth in earnings (or at least growth in earnings projections), even though it's possible for the S&P 500 price to climb without actually experiencing underlying earnings growth. Below, we chart the current S&P 500 P/E multiple (in navy), with earnings multiples between 14 times and 24 times in the background. As Figures 12 and 13 show, the multiple fluctuates over time, and the current P/E ratio of 22x has risen from 19 since the end of 2022 and is not historically extreme.

### Figure 13: Price-to-Earnings Multiple Expansion

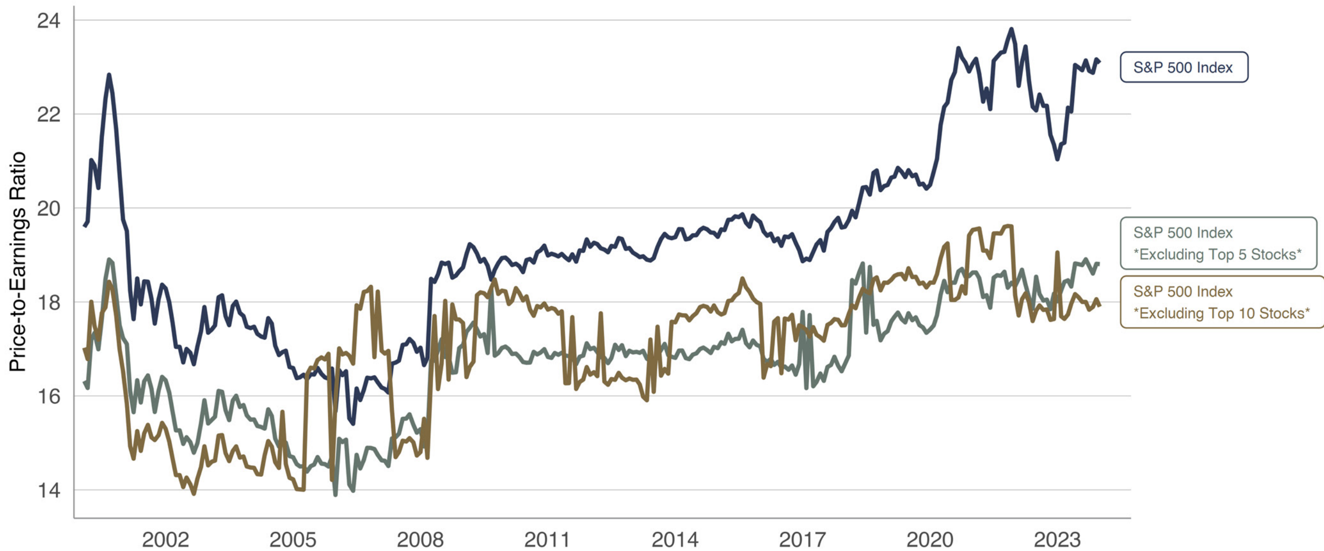



From 12.31.2002 through 12.31.2023. SOURCE: Kovitz using data from Bloomberg Finance L.P.

## S&P 500 INDEX EXCLUDING THE TOP STOCKS

Recent gains have been propelled by a handful of stocks. Over the last five years, just five stocks (Apple, Microsoft, Nvidia, Amazon and Meta Platforms) have accounted for 35% of the S&P 500's 107% rise. The Top 10 stocks have driven nearly half of the returns. Large weights and somewhat expensive valuations thanks to soaring prices that have not been entirely backed by earnings growth resulted in an aggregate index that appears substantially more expensive than the mean stock.

### Figure 14: S&P 500 P/E Ratio Excluding the Top 5 and Top 10 Stocks




From 01.31.2000 through 12.31.2023. Harmonic mean of the price-to-earnings ratio. To approximate the S&P 500 index constituents, the study selected the largest 500 stocks in the Russell 1000 index each month and re-weighted the constituents. SOURCE: Kovitz using data from Bloomberg Finance L.P.

## VALUE STOCKS REMAIN ATTRACTIVE

One of the most common valuation metrics, the P/E ratio, measures the price an investor pays for a unit of earnings. While Value (stocks with lower P/E ratios, per the S&P 500 Value index), has seen its ratio rise above longer-term averages, Growth (stocks with higher P/E ratios, per the S&P 500 Growth index) is much further above its historical norm. We think this discrepancy elevates the attractiveness of Value on a relative basis.

### Figure 15: Returned from Space – Growth Valuations (by P/E)

From 06.30.2001 through 12.29.2023. 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 (P/B) ratio. It measures the difference between a company's market value (i.e. market capitalization) and book value (assets less liabilities). As measured by the P/B ratio, the valuation gap is larger than usual these days, after narrowing in 2022 and modestly expanding again in 2023.

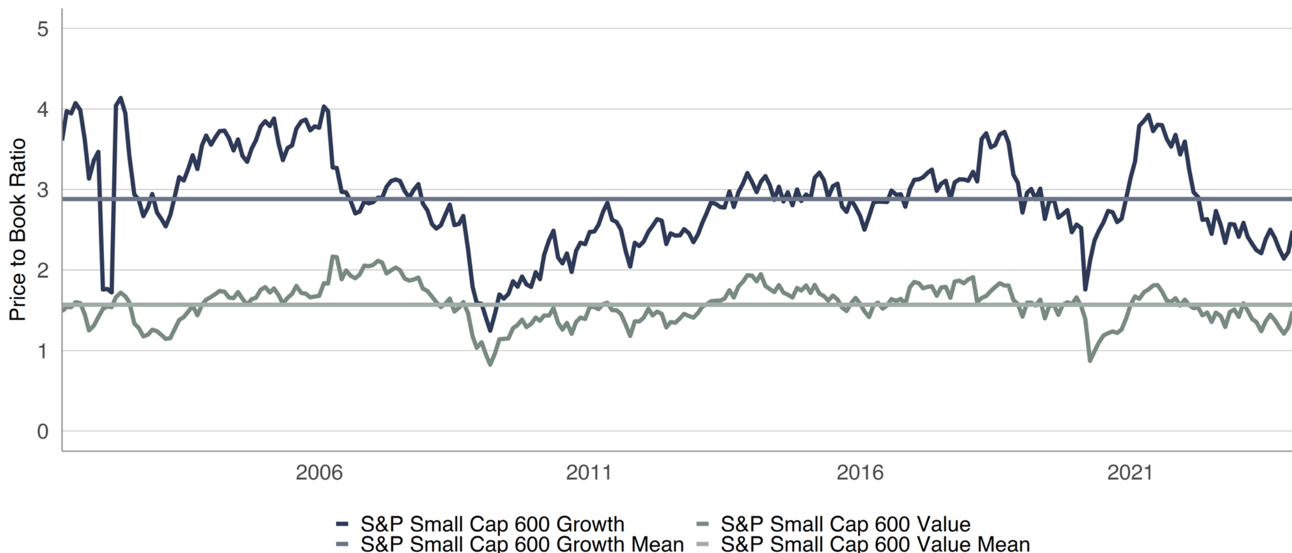
### Figure 16: Crashing Down – Growth Valuations (by P/B)

From 03.31.2001 through 12.31.2023. SOURCE: Kovitz using data from Bloomberg Finance L.P.

## SMALL CAPS

Whether located on the Value or Growth end of the spectrum, Small-Caps presently trade at significant discounts to their historical average multiples. When compared against the Large-Cap S&P 500 values in Figure 16, the relative inexpensiveness of Small Company stocks is even more pronounced. The differences in valuations are in part due to the Tech-heavy rally in 2023, which pushed the S&P 500 index 26% higher, while the average stock's return was about half that figure.

### Figure 17: Small Company Stock Valuations Are Cheap

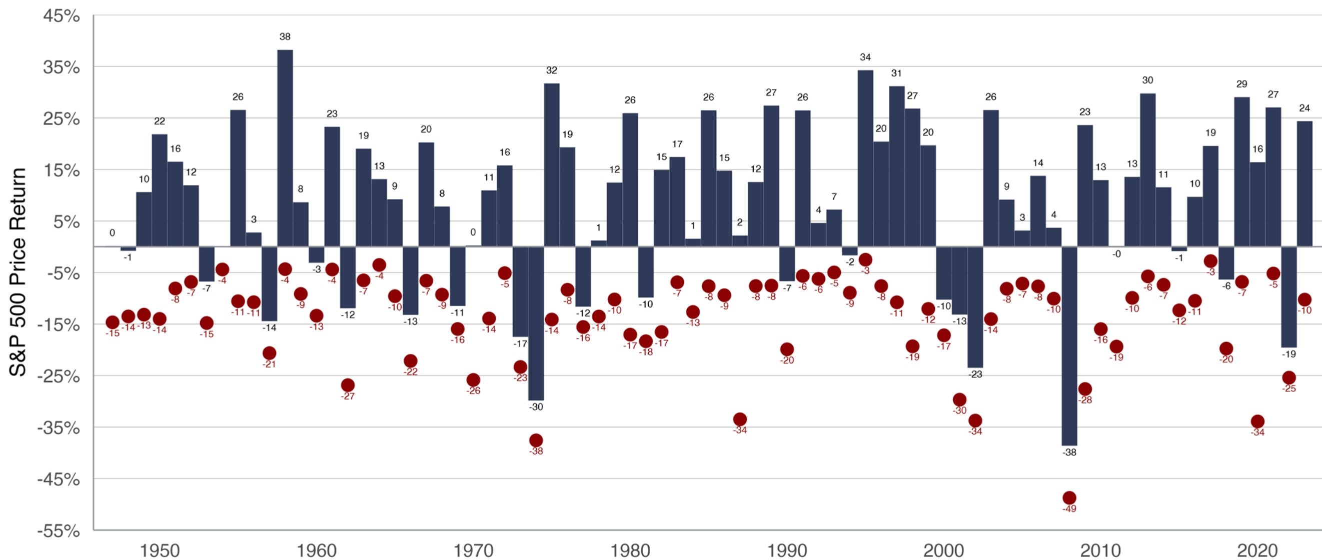



From 03.31.2001 through 12.31.2023. SOURCE: Kovitz using data from Bloomberg Finance L.P.

## EQUITY MARKETS GO UP (AND SOMETIMES DOWN)

One of the best illustrations showing annual stock market gyrations is offered below. The red dots mark the low point each year (peak to trough) and the navy bar is the final price 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. Last year, the S&P 500 dropped as much as 10%, yet ended the year up 24% (excluding dividends!).

### Figure 18: There Will be Bumps in the Road




From 12.31.1946 through 12.31.2023. 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 RALLY MAY CONTINUE

In our 2024 Stock Market Outlook, we discussed seven investment themes for the upcoming year and offered a friendly reminder that 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. The 18 preceding charts endeavor to add color to what we wrote in the Outlook by presenting historical context for tidbits that might be presented as points to worry about in the future. And of course, those remarks are usually offered with minimal context and oodles of chutzpah, largely because that sells well on TV or in the newspaper. We must live with such prognostications, even as they do not help folks stay on the path to success.

We do not mean to suggest that the ride in down the stock market road will be free of wacky gyrations, stress or worries. Indeed the year is off to quite a start, with the first few days of trading lively. Yet, we think those with long-term time horizons stand to benefit from their patience and persistence, having always been rewarded in the fullness of time. Unsurprisingly, the kind folks in our Compliance department will want us to caution that past performance is not indicative of future results and there are no assurances the next century will be like the last, but we see no reason to temper our enthusiasm for our broadly diversified portfolios of undervalued stocks. When inevitable market drops do occur or we become less certain about our convictions, we remind ourselves of this quote from Warren Buffett's 2020 letter, "In its brief 232 years of existence, however, there has been no incubator for unleashing human potential like America. Despite some severe interruptions, our country's economic progress has been breathtaking."

## PARTNER WITH US

For more than 46 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:


**Jason R. Clark, CFA**

**Principal, Portfolio Manager**

949.424.1013

jclark@kovitz.com


## DISCLOSURES

Opinions expressed are only our current opinions or our opinions on the posting date. Any graphs, data, or information in this publication are considered reliably sourced, but no representation is made that it is accurate or complete, and should not be relied upon as such. This information is subject to change without notice at any time, based on market and other conditions. The description of products, services, and performance results contained herein is not an offering or a solicitation of any kind, always consult with your tax advisor.

The description of products, services, and performance results contained herein is not an offering or a solicitation of any kind. Past performance is not an indication of future results. Securities investments are subject to risk and may lose value.

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 Standard & Poor's 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.

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.

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).

Kovitz Investment Group Partners, LLC ("Kovitz") is an investment adviser registered with the Securities and Exchange Commission. The information and opinions expressed in this publication are not intended to constitute a recommendation to buy or sell any security or to offer advisory services by Kovitz. The material has been prepared or is distributed solely for information purposes and is not a solicitation or an offer to participate in any trading strategy, and should not be relied on for accounting, tax or legal advice. This report should only be considered as a tool in any investment decision matrix and should not be used by itself to make investment decisions.