

Winter 2022 – 2021 Report Card

By: Henry Pizzutello, Chief Investment Officer

The annual task for portfolio managers at the start of every January is to spend time coming up with market opinions and predictions as to what may the upcoming year hold. Predictions of future returns, however, are almost always an exercise in futility. Since 2000, the median forecast that has been made by the most prominent Wall Street strategists has missed its target by an average of 12.9 percentage points — which is actually more than double what the average annual performance has been over that time. Knowing this history, we believe that there is little value in price prediction, but we do see value in a review of the thoughts regarding the investment themes made at the beginning of last year. While these “predictions” do not necessarily lead to performance, it does provide a window into how clearly the thesis is communicated through the investment process.

In our Winter Edition 2021 “Three Things to Watch”, we made the following observations for 2021.

1. Cold War 2.0

“The net result may be somewhat slower economic growth and potentially higher inflation over the long-term”

We have certainly seen the increase in prices this year and while there are numerous factors behind the rise in inflation, the supply chain issues are a direct result of the tension between U.S. and

China were at the forefront. Global growth has slowed from the torrid recovery pace of last year, and one of the key drivers in the recovery will be how China and the U.S. deal with trade issues in 2022.

2. Value versus Growth

“The expectation of a much stronger global economy this year, and the recent strong performance of the financial and energy sectors, make for a combination with historically good correlation for value outperformance”.

This largely played out as we thought. While growth stocks still provided good returns, the “value discount” to growth stocks that had been widening since 2015 narrowed considerably. Index returns have been fueled by the performance of the mega-cap FAANG growth stocks (Facebook, Apple, Amazon, Netflix, Google) as well as other high growth names like Tesla and Nvidia, among others. Concerns that broad market indices such as the S&P 500 were skewed by performance of the top 5 names have been well documented as these mega-cap companies account for as much as 23% of the index return. Compared to the “equal weight” S&P index, which weights each stock equally regardless of size, the cap weighted index has significantly outperformed since 2015. Last year, however, the equal weight index (which includes a more representative value component) provided the same return as the cap weighted index.

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3. The Bubble Doesn't POP

“With the Fed funds rate likely to be pegged near zero until 2023, the party punch bowl still looks appealing.”

While the recent comments by the Fed may change this in 2022, the Wall Street maxim “don’t fight the Fed” certainly proved true in 2021, and was a key factor in our investment thesis at the beginning of the year. However, there were also a number of other factors that made us comfortable that the “party” would continue – U.S. election resolution, continued progress on the COVID pandemic, and continued economic growth.

All in all, these “predictions” as they were, proved to have been on the mark. Someone might argue, “If you were right on all of these predictions, why wasn’t the portfolio invested in U.S. value stocks that did well when inflation rises? We would have made a lot more money.” While true, that is not really the point of the exercise. As we have said many times, we do not construct a portfolio based on predictions – rather, the thesis behind our investment rationale enables us to create a portfolio with the least amount of risk that still attains our return expectations.

Things to Watch for 2022

Now that we have reviewed our 2021 themes, what do we think is in store for 2022? Unsurprisingly, a lot of what we think is important has to do with the two themes that have been a focus over the past two years – the emergence of more structural inflationary environment and the increasing risk of a mid-term election year.

Inflation and Politics

From a forecast perspective, the view is actually easier for stocks than for bonds. The last significant inflationary period for the U.S. (1968 to 1985) included four recessions. Many forecasts have argued that the debate over inflation as a choice between the double-digit inflation of the 1970s versus an increase in prices that will prove to be only “transitory.” We believe a little of both sides. While some supply shortage issues will undoubtedly ease, both in labor and inventories, we believe that overall inflation will be more structural, particularly regarding housing and wages. For the first time in 40 years, inflation and the Fed’s ability to deal with it will be a political consideration in November. This will be a tricky exercise, as higher rates may quell inflationary forces, but also derail a strong economy and stock market.

Politically, this may work against the current Democratic agenda of “tax and spend”. It remains to be seen how market reaction will affect proposed legislation relating to increasing taxes on capital gains and income, and ultimately affect the November mid-term elections.

From a market perspective, we believe that this will lead to a lower return profile for equities than we have seen over the past few years, even if earnings remain strong. One main reason is that the market multiple tends to contract in higher inflationary environments. The average market multiple since 1950 when inflation expectations have been between 2%-3% is 18x, as opposed to the current market multiple of 21x. With inflation currently running at 5% (although expected to moderate) the potential for multiple contraction will limit upside, even in the face of strong earnings.

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Value vs. Growth 2.0

While the value gap closed in 2021, we expect that to continue, especially among the high-beta, high growth names. The Russell 3000 has the highest percentage of companies trading above 10x sales in its history. If our view that structural inflation will lead to higher long-term interest rates proves correct, the companies whose value is tied almost entirely to their growth will suffer the most.

Why is 10x sales such an important metric? Scott McNealy, CEO of Sun Microsystems, made this comment in 2002.

“...2 years ago we were selling at 10 times revenues when we were at \$64. At 10 times revenues, to give you a 10-year payback, I have to pay you 100% of revenues for 10 straight years in dividends. That assumes I can get that by my shareholders. That assumes I have zero cost of goods sold, which is very hard for a computer company. That assumes zero expenses, which is really hard with 39,000 employees. That assumes I pay no taxes, which is very hard. And that assumes you pay no taxes on your dividends, which is kind of illegal. And that assumes with zero R&D for the next 10 years, I can maintain the current revenue run rate. Now, having done that, would any of you like to buy my stock at \$64? Do you realize how ridiculous those basic assumptions are? You don’t need any transparency. You don’t need any footnotes. What were you thinking?”

McNealy sold his company for \$9.50 / share in 2009.



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Balance of Downside and Upside

While downside protection is always important, there are some market environments which put a premium on this as a risk factor. We have previously discussed multiples and potentially higher yields as market headwinds, but these do not mean markets cannot continue to move higher. In 1987, the S&P increased almost 40% as rates rose 200 basis points until the October crash reset things. In 1999, the NASDAQ rose more than 80% as rates increased. Ultimately, this valuation extreme was also resolved a few years later. While we don't believe we are in that type of environment, as there are other positive structural issue today that were not present then, we would be foolish to ignore history.

Toward that end, our portfolio exposures will be more diversified and have a primary focus on sectors that will have a more positive correlation to these factors. Value based equities, commodities, and higher income assets will provide more protection than high-growth, high risk momentum choices.

Within fixed income, we will continue to focus on higher quality, shorter-duration exposures as we are currently positioned. Given the potential for upside and the strong credit environment, selected exposure in tactical high-yield will be attractive.

