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Year-End Outlook

Anybody Worried?

Investors certainly have plenty to worry about, starting with the unpredictability of the Covid viruses. Also, the valuation of the S&P 500, heavily weighted by large cap tech stocks, is selling at one of the most expensive levels in history. In addition, US government debt is also at one of its highest levels in history. Additional concerns are that speculative trading in various new areas of the market is reminiscent of the wild speculation of the 1960s, and inflation has started aggressively turning up, which is usually a lead indicator for interest rates. We can fill pages on the other various concerns, but we think it is worth pointing out there is always something to worry about every year.

Regarding these yearly concerns, in our office we have a study going back to the 1930s, pointing out how in every single year there was always at least one big worry. The range from one year to the next might be that one year the market was too high on a valuation level, and another year looked like the end of the world. Meanwhile over that 85-year time-period, the market was up a phenomenal amount, so the message was not to get bogged down with what is going on in any one year, but to be investing on a longer-term basis.

This long-term perspective reminds us of the advice that Ben Graham gave at the end of his career:

> **"If investors in the stock market invest with a discipline (P/E, P/B and dividend yield) and if they invested for the long term, they could forget everything else."**

When we first heard this advice back in the 1970s, one had to raise an eyebrow in disbelief, but history shows you could forget everything else if you focused on both parts of the strategy. So, let's take a look at the record.

It's the Combination: Value Discipline + Long Term Approach

We know that markets are extremely unpredictable on a short-term basis, but our experience shows that using a 5-year time-period does a remarkable job smoothing the market's volatility and performance, even in the worst periods. To illustrate, below is a study showing the performance on a rolling five-year basis of the lowest P/E stocks of the S&P 500.

Performance of low P/E stocks in five-year periods (1968–2020)

Period	S&P 500 Bottom 20%by P/E	Period	S&P 500 Bottom 20% by P/E
1968–1972	8.00%	1993–1997	22.50%
1969–1973	−0.90%	1994–1998	18.70%
1970–1974	0.40%	1995–1999	19.70%
1971–1975	7.60%	1996–2000	16.60%
1972–1976	14.10%	1997–2001	16.10%
1973–1977	14.20%	1998–2002	7.00%
1974–1978	21.10%	1999–2003	14.30%
1975–1979	30.70%	2000–2004	17.40%
1976–1980	26.10%	2001–2005	15.80%
1977–1981	20.40%	2002–2006	16.20%
1978–1982	24.40%	2003–2007	18.20%
1979–1983	27.30%	2004–2008	0.20%
1980–1984	24.50%	2005–2009	4.80%
1981–1985	24.80%	2006–2010	5.60%
1982–1986	27.70%	2007–2011	2.40%
1983–1987	20.10%	2008–2012	5.60%
1984–1988	20.00%	2009–2013	25.30%
1985–1989	21.20%	2010–2014	17.70%
1986–1990	10.50%	2011–2015	13.70%
1987–1991	13.10%	2012 -2016	17.20%
1988–1992	18.10%	2013–2017	17.60%
1989–1993	16.00%	2014–2018	6.40%
1990–1994	11.90%	2015–2019	9.00%
1991–1995	23.90%	2016–2020	7.80%
1992–1996	18.60%		

Source: SCCM. ***Past performance does not guarantee future results.***
Investors cannot invest directly in an index.

In a second table we show that any time the five-year period was up less than 5%, the next five-year period was exceptionally strong.

Performance Following Difficult Five-Year Periods

Poor Five-Year Periods	Bottom 20% by P/E	Following Five-Year Periods	Bottom 20% by P/E
1969–1973	−0.9%	1974–1978	21.1%
1970–1974	0.4%	1975–1979	30.7%
2004–2008	0.2%	2009–2013	25.3%
2005–2009	4.8%	2010–2014	17.7%
2007–2011	2.4%	2012–2016	17.2%

Source: SCCM

Ten Year Performance

The ten-year study shows how the longer-term time period smooths performance even more dramatically. While the average investor can identify more with a five-year period than a ten-year, for longer-term investors, especially institutional investors, it's hard to believe that more are not using the strategy.

S&P 500 Bottom 20% by P/E—Annualized 10-Year Returns

	Bottom 20% by P/E
2011–2020	10.70%
2010–2019	13.25%
2009–2018	15.42%
2008–2017	11.45%
2007–2016	9.55%
2006–2015	9.58%
2005–2014	11.06%
2004–2013	12.05%
2003–2012	11.73%
2002–2011	9.07%
2001–2010	10.57%
2000–2009	10.92%
1999–2008	7.03%
1998–2007	12.45%
1997–2006	16.13%
1996–2005	16.20%
1995–2004	18.55%
1994–2003	16.46%
1993–2002	14.49%
1992–2001	17.36%
1991–2000	20.23%
1990–1999	15.72%

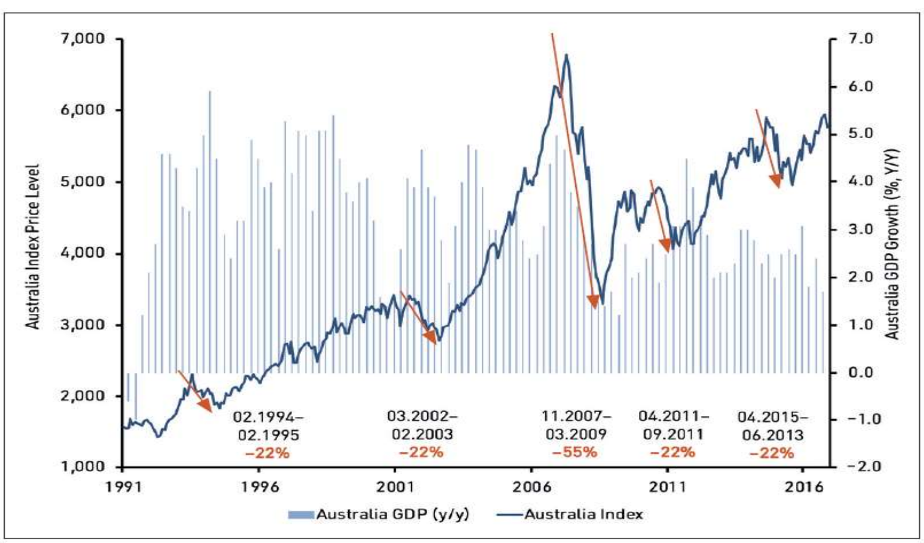
Source: SCCM

A New Era?

Market history shows that every long bull market always produces a belief that a new environment of innovation has produced a breakthrough so overwhelming that the stocks of the breakthrough companies will resist any correction. The idea dates back to the 1920s when RCA, Ford, General Motors, and AT&T were all dominating the market. But when it finally crashed in 1929, these giants collapsed along with all the other stocks – the whole market dropped about 80%. Similarly, during 1960 and 1970s, the era of the *Nifty Fifty,* companies like Xerox, IBM, Eastman Kodak and Polaroid were thought to have such phenomenal growth potential that any price one paid for them would be bailed out eventually by ever rising earnings. That of course didn't happen. Most recently, we had the Tech Bubble and a "*New Paradigm"* that became the mantra of an era. But when the market eventually rolled over, the descent for the new paradigm stocks was long and deep.

In addition to all else, a macro-economic theory has recently gained prominence among some economists and politicians. It's called Modern Monetary Theory (MMT), which asserts that the economy can be kept from ever falling into recession and the market from ever correcting itself by the federal government simply pumping ever more money into circulation. In fact, in one of our market letters, we talked about a real-world example of an economy that did grow without a recession. This happened in Australia when it was benefitting from huge Chinese demand for Down Under commodities. The Australian economy grew for an unheard of 25 years in a row without a downturn.

But the Australian stock market during the same 25 years experienced five corrections of over 25% and one over 50%, even as the economy grew without a recession. In fact, during those 25 years, the Australian stock market lagged that of the U.S., even as ours was pounded by the 9/11 attacks and the subprime crisis. The lesson here is that avoiding an economic recession is no guarantee that stocks will not correct from overvaluation.



Source: Bloomberg June 30, 2016

A Time for Value

In recent market letters, we have said that since the announcement of the Covid vaccines on November 6, 2020, value strategies, which had been out of favor for about ten years were beginning to show stronger performance. Updating our High Dividend Value's strength since November 6, we see that as of December 17, 2021, the High Dividend portfolio is **+36.2%** versus **+28.5%** for the S&P 500. This happened even though the S&P has had approximately 67 new highs during the same time, which usually produces a bonanza for growth stock investing.

Conclusion

Periods of high inflation, high government debt and rising inflation tend to result in slower overall economic growth and very strong relative performance for value investing and this especially is the case when one factors in dividends.

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