Warnke/Nichols Ltd.

Investment Management

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PORTFOLIO NOTES **SEPTEMBER 2020**

To our Business Partners:

- ***OWNING THE TECH DARLINGS.*** We have recited, ad nauseum, over the last several months the significant influence a small group of technology stocks (Adobe, Amazon, Apple, Facebook, Google, Microsoft, Netflix, Nvidia, Tesla) have had on the market indexes. They have pushed the major indexes into positive territory, while most of the rest of stocks have produced negative returns. So why not just own the highfliers? We bought a couple of them in the past when they sold at reasonable valuations, and did quite well. But, of course, as we often do when they go up a lot and sell at or above estimated value, sold them too early and missed the latest manic melt-up in prices.

  One relatively simple test in our research toolbox is "earnings payback." It's a calculation most businesses do whenever they are considering an acquisition or a capital project. The operator of the business tries to answer the simple question, "How many years will it take the total net earnings of the new business or machine or building to equal my initial investment?" If a business owner can't earn a decent return on a new purchase over a reasonable period of time, why invest in it?

  Here's how the math works. It's not unusual these days to see a company earning, say, 2 cents on every dollar of stock price (a price-earnings ratio of 50), with an expected future earnings growth rate of, say, 30%. At that rate, it takes nearly 11 years for total earnings to equal the initial investment. This is an unacceptably long payback period which yields a lousy rate of return to the owner. Not only is the two-cents-per-dollar earnings rate low, a 30% annual growth rate for 11 years is highly unlikely. A slower earnings growth rate makes the payback period even LONGER. By contrast, a much less glamorous company selling at 10 times its earnings, growing a modest but more sustainable 10%, yields a payback period of just over 7 years!

  Intelligent investors have seen numerous versions of this movie over the last 100 years. Buyers of "growth stocks" consistently overestimate the rate and duration of company earnings. Prices reach seemingly stratospheric levels with new valuation metrics introduced to justify the valuations. It's easy to get caught up in the growth stock excitement, but the investor faces significant risk because, as prices rise, future returns decline. These periods of significant overvaluation can go on much longer than expected, as they now have. But, without a rational basis for comparing prices to values, speculation becomes rampant, and history shows these movies often have unhappy endings.

- ***VALUATION.*** Price to value calculations have gotten more favorable during the past month, as evidenced by our group of widely held stocks selling at 69% of estimated worth. Several stocks meet our tests of financial soundness and profitability, while selling at large discounts to value.

- ***RECENT RESULTS.*** Market indexes rose again in August, led by the indexes heavily weighted toward large company stocks. The NASDAQ Composite and the S&P 500 gained 9.6% and 7%, respectively. Indexes made up of small company stocks continued to lag, with gains of 3-4%. Over the last 12 months, there's been some improvement in small vs. large, but there is still a huge gap in performance. The S&P 500 is up nearly 20% over the last twelve months, while the S&P 400 (mid-cap) Index is up 2.4% and the S&P 600 (small-cap) Index is down 2.2%. The influence of the few favored stocks remains overwhelming. Our widely held stocks* have tracked the best of the smaller company indexes but, because we don't own the tech heavyweights, remain behind the NASDAQ and S&P 500.

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The group of "portfolio stocks" -- our Equity Composite for the purpose of evaluating investment performance -- consists of 18 stocks that are held in our clients' accounts. Portfolios might hold some or all of these stocks, depending on investment guidelines unique to each client, the timing of purchases and sales, and start dates of accounts. The performance of this group of stocks is a good proxy for our equity performance but might vary widely among accounts. Of course, past performance is not necessarily indicative of future results.

We hereby offer to deliver to you without charge a copy of our current Form ADV Part 2, in accordance with the U.S. Securities and Exchange Commission's "Brochure Rule." Please contact us if you would like us to send you a copy.

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