Warnke/Nichols Ltd.
Investment Management

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PORTFOLIO NOTES **OCTOBER 2020**

To our Business Partners:

- ***MARKET MANIPULATION AND LOW FUTURE RETURNS.*** The US Federal Reserve has been intervening aggressively in the financial markets whenever there have been significant stresses on the economy and the markets. The most recent intervention during the Covid-19 crisis is no exception. The Fed has engineered interest rates down to near zero and has also injected liquidity into the financial system through direct purchases of mostly US Treasury securities – bills and bonds. The US Congress has also gotten into the act with massive fiscal stimulus through direct payments to individuals and interest-free loans to companies, among other moves.

  All this monetary and fiscal stimulus has had the desired effect on the stock market, pulling it out of a deep dive last March and pushing stock prices back to the old highs achieved in February prior to the pandemic. Stock prices move day-to-day seemingly based on the rise and fall of hopes for even more government stimulus and/or Fed intervention. For the past 20+ years, this fine-tuning (manipulation?) of economic activity has limited the downside that normally occurs after economic booms. Unfortunately, there are serious negative consequences of such actions.

  Many market observers opine that stocks continue to be the most attractive of any asset due to interest rates being close to zero. (A popular phrase these days is "TINA" – There Is No Alternative.) Because the calculation of future business values is based on interest rate assumptions, the bulls argue that valuations must be adjusted upward to reflect low interest rates. This has certainly been a major factor in the stock market recovery, as stock prices have been bid sharply higher, even though company profits have plummeted due to this year's pandemic induced economic downturn.

  BUT … such logic also means that stock investors should expect generally mediocre future returns. Extremely high valuations, such as exist today, ALWAYS lead to lower long-term returns. The other problem with the bulls' argument is that they assume interest rates will remain low forever … not likely! While rates may remain low for a while yet, they will eventually reverse course, as the supply/demand for money remains highly cyclical. We'll not fall into the valuation trap, as we prefer to use valuation standards that rely on achieving an acceptable rate of return over time.

- ***VALUATION.*** We're turning over a lot of rocks to try to find value, but there's not a lot to get excited about. What's holding us back? Stock prices to earnings/assets/cash flow/dividends are too high. Next, even good companies have taken on too much debt (we hate debt). And many companies that qualify via our screening process are in industries we don't care for.

- ***RECENT RESULTS.*** All market indexes declined in September. The NASDAQ Composite was down over 5%, while most other indexes dropped 3-4%. Over the last 12 months, there's still a large gap between performance of the major indexes and smaller company indexes. The S&P 500 is up nearly 13%, while the S&P 400 (mid-cap) Index is down around 4% and the S&P 600 (small-cap) Index is down nearly 10%. The median stock (the one in the middle of the list) on the New York Stock Exchange is down over 14%. THAT'S how "the market" is truly performing, as several large companies in the major indexes continue to mask a bigger decline. The top five stocks in the S&P 500 – all tech stocks – account for a record percentage of the index. The last time we saw this kind of concentration was in early 2000, prior to a 22-month, 50% drop in the index. Our widely held stocks*, as a group, compare favorably with the small- and mid-cap indexes.

Steve Nichols, CFA   Bill Warnke, CFA

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.

Investing with a margin of safety.™

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