Warnke/Nichols Ltd.
Investment Management

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PORTFOLIO NOTES **January 2021**

To our Business Partners:

- ***A YEAR TO REMEMBER (OR, MAYBE NOT).*** 2020 is without a doubt one of the most unusual years we have ever encountered in our investment careers. In March investors were faced with the coronavirus and a nationwide lockdown. Stock prices plummeted as economic activity nearly ground to a halt. With an assist from the Federal Reserve and their aggressive market intervention (manipulation?), markets rallied back and erased the March declines in a matter of months. However, markets were largely dominated by companies perceived to be lockdown winners, those with a heavy concentration in technology. These and other so-called "growth" companies have been dominating index performance for some time, and this became even more pronounced in recent months.

  But, a deeper look at individual stock performance reveals a different story for the year. While the index was UP (only) 4.4%, more than half the component stocks on the New York Stock Exchange were DOWN in 2020. In addition, from a valuation standpoint, the gains recorded in 2020 were entirely due to price-earnings multiple expansion, because company earnings were terrible. (In other words, the "P" in the price-earnings ratio went up a lot, while the "E" actually went down.)

  Because of the way most indexes are calculated, the larger market-value companies have a significantly greater impact on the indexes' performance. Many indexes have become extremely "top-heavy," thus skewing results. (To illustrate, the top 1% (20) of NYSE companies accounts for over 21% of the index. The less populous Dow and S&P are even worse!)

  While we view 2020 as a short-term event in a long investment time horizon, its effects may linger for a time. Unfortunately, the economic debacle, plunging earnings, diverse performance, Fed manipulation, and schizophrenic investor sentiment have created some significant distortions in the financial markets, which we believe will eventually be corrected – perhaps to the downside. Factors such as profitability, financial soundness and, of course, valuation, will again become important.

  VALUATION. Stock prices are still extremely high relative to virtually every measure of value. "*Right now, due to the extraordinary circumstances in the world, politics, the economy, monetary policy and more, the urge to 'do something' is even greater than normal. However, the opportunity to put money to work is simply not there. At least not yet. But it's coming. And until it does, the most proactive thing an investor can do is simply commit to doing nothing, understanding that that is not a passive decision but a very proactive one, indeed*." (Jesse Felder, "The Felder Report" blog).

- ***RECENT RESULTS.*** Markets rose in again in December, meeting expectations for the annual "Santa Claus rally." Indexes rose from 3-8%, with the smaller company indexes again enjoying the largest increases. Results for the year are widely scattered, but mostly positive for all the indexes we monitor. The lone exception is the median return of stocks on the New York Stock Exchange, which was a negative 1.5%. The S&P 500 recorded a gain of about 18%, while the S&P 400 (mid-cap) Index is up about 12% and the S&P 600 (small-cap) Index is up about 9%. Our widely held stocks*, despite a strong finish in 2020, lagged behind the indexes over the last year.

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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.

Investing with a margin of safety.™

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