Warnke/Nichols Ltd.
Investment Management

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PORTFOLIO NOTES **February 2021**

To our Business Partners:

- ***EVERYBODY GETS A TROPHY***. In the real economy and business, there are always winners, losers, and also-rans. However, in the securities markets these days, stocks are being priced as though everyone is going to win. The stocks of many companies are trading at extremely high valuation levels, particularly in younger emerging sectors, where growth appears to be superior and long-lasting.

  But historical activity suggests otherwise. Data from 1980 through 2019 for all the companies in the S&P 500 Index reveal how difficult it is to sustain growth. Using a threshold of 5% earnings growth, a seemingly modest hurdle, it was found that over a 5-year time frame only about 6% (1 out of every 16) of the 500 companies were able to achieve more that 5% year-over-year growth. With a ten-year time frame this number drops to under 1% (that's fewer than 50 S&P 500 companies!).

  Within the always-popular technology sector, the challenge to sustain earnings growth is even greater. Within the same 5- and 10-year time frames, the ability of a technology company to achieve at least a 5% growth rate *drops to 4.4% and 0.2%*, respectively. In other words, amazingly, only a handful of tech companies could sustain earnings growth greater than a mere 5% annually.

  While successful high-growth companies can easily be identified after the fact, they are few and far between. Markets have always tended to award potential rapid earnings growth with very high valuations, with the assumption that growth will last for long periods of time. The longer a bull market lasts, the more widespread this perception becomes. Unfortunately, actual results fall short of the wildly optimistic assumptions. Superior growth almost always attracts increased competition, which eventually reduces profitability. Companies that overcome competitive pressures and remain high-growth are few and far between. Today's valuations, especially among tech-related companies that appear "priced to perfection," leave little room for errors in judgment or forecasting.

- ***VALUATION.*** Stock prices are still extremely high relative to virtually every measure of value, whether it's price to earnings, sales, asset value, cash flow, or dividends. Perhaps the most extreme measure is what is sometimes called "The Buffett Indicator," believed to be Warren Buffett's favorite measure of stock market valuation. The total market capitalization of the U.S. stock market compared to U.S. economic output is a whopping 170% -- by far the highest in history. Future stock market returns from this high level might not match the past several years. Fortunately, we can gain an edge by ignoring "the market," and select a few =high quality stocks selling at cheap valuations.

- ***RECENT RESULTS.*** Markets were mixed in January, with both the S&P 500 and Dow Jones Industrials down 1% and 2%, respectively. Most of the other indexes we monitor rose modestly, in the 1-2% range, with the notable exception of the small company indexes which, rebounded 5-6%. The median return of stocks on the New York Stock Exchange (the "average stock") was a marginal 0.2%. Our widely held stocks* performed within the January range of most of the indexes but lags behind index returns over the last twelve months.

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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.***

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