4th Quarter 2021 Review

2021 was another strong year for stocks as markets dealt with a strong rise in inflation, two new Covid-19 variant threats and what is likely the beginning of the end of an era of excessive monetary and fiscal stimulus programs. Despite this, corporate earnings surged over 40% from the prior year Covid-induced lows, driving stock prices to record levels.

The price gains for the major indices for the year were: The Dow Jones Industrial Average rose 19%; the S&P 500 was up 27%, the Russell 2000 Small Cap Index was up 14%, the NASDAQ rose 21%, and the broad Value Line Index rose 19%. International equities lagged the U.S. markets with emerging market stocks falling 5% on the year, while the MSCI EAFE Developed International Index rose 8% for the year. The broad investment grade bond market declined 3.4% for the year, as the 10-yr treasury yield moved higher for the year.

The events that have unfolded over the last couple of years and the way the markets have reacted to them have surprised many in the game of market predictions. It reminds us of the wit and wisdom and this whimsical quote from New York Yankee great, Yogi Berra when he said, “It’s tough to make predictions, especially about the future.” Following predictions is a tough way to invest. Many are now making bold predictions about the future pace of inflation, rates, and markets. The surge in inflationary pressures brought on by the uneven recovery in economic activity between the goods sector and the services sector of the economy is just one example of the major distortions brought on by the pandemic. The Covid-19 lockdowns brought on a surge in demand for goods and a huge contraction in the ability to consume services. This occurred while the supply of those goods in such high demand was drastically constrained. The result was a classic recipe for higher inflation. The path forward from here is not so cut and dry. There will be normalization in the data and the Federal Reserve (Fed) will have a tough task in deciphering the noise from the underlying trends. A key point we will be watching for is if market pricing moves decisively in one way, perhaps too far- and ignores the part about the Fed being highly data dependent. Supply chains and labor market dynamics have been largely impacted by forces related to the pandemic. As these recede, and policy stimulus wanes, we expect high levels of asset price volatility.

Much of the fuel that has propelled the high-growth-no-profits segment of the market has been the ultra-low interest rate environment. Now with inflation rising and the Fed committed to slowing the growth of its balance sheet to prepare for the eventual hiking of interest rates, we will begin to see just how much tightening of policy markets can withstand and how much growth has been pulled forward relative to expectations. With so much of the recent economic activity being impacted by Covid-related stimulus and disruptions, it is difficult to get a clear read on the normalized level of economic activity, and thus the sustainability of inflationary pressures and the appropriate level of interest rates. For these reasons and more we think it is prudent to avoid making large one-way bets on the directionality of these variables.

As the year progresses, we expect more clarity on the direction of growth and its impact on the trajectory of inflation, rates and ultimately earnings. We expect periods of heightened volatility, which will likely produce new opportunities. Since we are not in the business of predicting the market- but rather the business of investing, we will control what we can control by owning durable businesses with consistent and growing earnings and attractive valuations.

For the S&P 500 broad market it was a year of strong earnings growth coupled with a small contraction in the PE (Price to Earnings) multiple. An interesting development towards the end of the year was the stealth bear market that occurred for a high percentage of companies in the indices where higher valuations began to come back to earth. As the year progressed the dispersion of market performance widened with many stocks experiencing bear market type declines, while the broad index returns stayed positive for the year. For example, based on data compiled by Alpine Macro Research, 60% of Russell 2000 stocks and 35% of NASDAQ 100 stocks experienced drawdowns of at least 20% sometime during the past 100 days.

Max Drawdown In The Past 100 Days	S&P 500	NASDAQ 100	NASDAQ Composite	Russell 2000
% Of Members With At Least 25% Correction	9%	23%	56%	47%
% Of Members With At Least 20% Correction	19%	35%	64%	60%
% Of Members With At Least 10% Correction	75%	76%	82%	92%
Average % Price Decline	-15%	-19%	-31%	-28%
Overall Index Maximum Drawdown % Decline	-5.9%	-8.4%	-8.3%	-14.2%

Source: Bloomberg

This reinforces our view that stock selection and fundamentals do still matter. This will be even more important in 2022 as some cracks in the story are beginning to emerge for the mega-momentum names with little or no current earnings. We expect more rotation in market leadership and see elevated levels of risk in the non-profitable companies that trade at multiples of 30-50 or more times revenues. You can only play the “growth will eventually catch up” card so long with valuations so stretched and the leveraged speculator community crowded into the same trades.

The reacceleration of earnings and the re-rating higher in the PE multiples of our core holdings propelled equity portfolios higher for the year. We believe that the outperformance that we experienced in 2021 with major moves in the cyclical, value-based companies is likely in the initial stages of a durable rotation within sectors of the market. Companies with secular tailwinds in areas such as healthcare, semiconductors, infrastructure, and industrial spending have both valuation support and strong revenue growth prospects. It is the valuation support that we are most interested in when deciding where to invest. Many of the top companies in the index have strong revenue and earnings growth and durable business models. But if the relative attractiveness of the future 5–10-year return potential is less compared to other companies with better valuation support (and potentially more upside over that same time horizon), we will choose the better value. Much of our past success has been the result of identifying attractive values in the smaller or mid cap size companies that eventually grow into larger cap companies. We expect this to be a continued source of returns for our equity investments. Dividend yields and dividend growth from stocks is also of growing importance to income investors in this low-yield environment. We have seen many of our core holdings raise their dividends in the last year, boosting the income contribution to portfolios.

Given the likelihood that 2022 will be a year where some Fed policy normalization occurs, we expect bond markets to be volatile and yields to rise moderately. We continue to favor shorter duration bond portfolios and active management to have the potential to exploit specific inefficiencies when they develop from this period of transition and volatility.

Alternative investments will continue to play a meaningful role in portfolios for the diversification of return streams and lower correlations to traditional stock and bond markets. Where appropriate, the illiquidity premium that can be earned by the inclusion of private alternatives can be a valuable contributor to both yield and return advantage over public markets. There are also alternative long/short strategies within the publicly traded markets in both equities and credit that benefit from the divergences between individual securities. Private debt can offer strong collateral backing the securities and a senior position in the capitalization of the business as a source of yield. Private real estate and other investments backed by cash generating assets can add yield and income diversification to traditional portfolios.

Successful investing is much more about making disciplined decisions *over time* as opposed to making bets on any *moment in time.* A disciplined, diversified strategy rooted in valuation analysis across asset classes should provide investors the opportunity to meet their financial goals while sleeping easy at night, knowing that they have a well-constructed portfolio strategy being executed in a thoughtful way. This is our objective for every investor, and what drives us every day to focus on our core values and philosophy rather than getting caught up in the short-term betting game in markets.

We wish you all the very best in 2022. Have a happy, healthy, and prosperous New Year!

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