Observations From A Year (Actually, Two). We've Never Seen It's Equal

It would seem counterproductive to look at these past 12 months in isolation. They were, instead, the second act of a drama that began early in 2020, the precipitant of which was the most significant global public health crisis in a hundred years.

The world elected to respond to the onset of the pandemic by essentially shutting down the global economy…placing it, if you will, in a kind of medically induced coma. We experienced the fastest economic recession ever in this country and a one-third decline in the S&P 500 in just 33 days.

Congress and the Federal Reserve responded all but immediately with a wave of fiscal and monetary stimulus, which was, and remained without historical precedent. This point cannot be overstressed: we are in the midst of a fiscal and monetary experiment with no direct antecedents. This makes all economic forecasting—and investment policy based on such forecasts—hugely speculative. I infer from this that ***if there were ever a time just to put our heads down and utilize our investment and financial plan—ignoring the noise—this is undoubtedly it.***

If 2020 was the year of the virus, 2021 was the year of the vaccines. Vaccination and acquired natural immunity are in the ascendancy, regardless of how many more Greek-letter variants are discovered and trumpeted to the skies as the new apocalypse. This fact, it seems, is the key to a coherent view of 2022.

In general, we think it most likely that in the coming year, (a) the lethality of the virus continues to wane, (b) the world economy continues to reopen, (c) corporate earnings continue to advance, (d) the Federal Reserve begins draining excess liquidity from the banking system, with some resultant increase in interest rates, (e) inflation subsides somewhat, and (f) barring some other exogenous variable—which we can never really do—equity values continue to advance, though at something more minor (and probably a lot less) than the blazing pace at which they've been soaring since the market trough of March 2020.

Please don't mistake this for a forecast. All we said, and now say again, is that these outcomes seem more likely than not to us. We are fully prepared to be wrong on any or all of the above points; if and when we are, our recommendations to you will be unaffected since our investment policy is driven entirely by the plan we've made and not at all by current events.

With that out of the way, allow us to offer a more personal observation. To wit: these have undoubtedly been the two most shocking and terrifying years for investors since the Global Financial Crisis of 2008-09—first the outbreak of the pandemic, next to the bitterly partisan election, then the pandemic's second significant wave, and most recently a 40-year inflation spike. Enough to make even the most seasoned investor somewhat fatigued.

But like that earlier episode, what came to matter most was not what the economy or the markets did, but what the investor did. If the investor fled the equity market during either crisis—or, heaven forbid, both—their investment results seem unlikely to recover. On the other hand, if they kept acting on a long-term plan rather than reacting to current events, positive outcomes followed. It was ever thus. We expect it always will be.

Why We Invest In Stocks

In an environment where nearly ALL assets have been increasing in value, and there seems to be a never-ending source of cheap money, there is no doubt the introduction of perceived new/better investment options. Maybe this is because investors are flush with capital, so they have no problem going out on the proverbial risk curve in an attempt to secure greater returns; or, they look elsewhere because they have now lost interest in what's got them here (i.e., stocks) because of the increased valuations; or, they are just plain bored with historically average annualized returns.

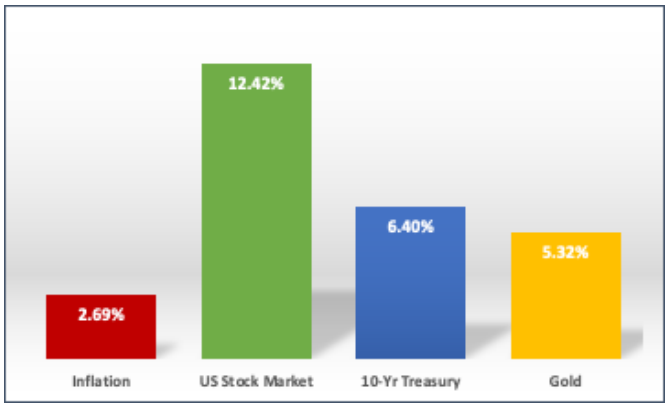
Whatever the reasoning, we've seen this behavior in the past, and we are seeing it again now. Hence, we've decided to devote the 2nd half of our annual letter to summarize the answer to the simple question: Why do we invest in stocks? Two evident but not always apparent reasons stand out for us.

1) Historically The Best Investment For The Average American

The name of the investment game is to build wealth. Dating back to 1926, the average annualized return of the stock market is 10.46% (through 12/31/2021 as measured by the S&P index). We would be hard-pressed to find another investment that even comes close to this figure for most of us.

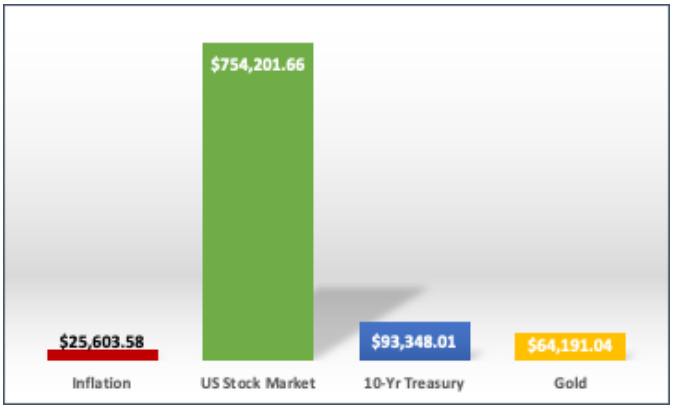
With the masses investing towards a goal of retirement, we make annual contributions for anywhere from 30 – 40 years, depending on when we start. Therefore, rather than look at 95 years of history, let's focus on the past 35 years.

The stock market has done better than 10.46%, registering a 12.42% annualized return. Even more impressive is how far it has outpaced other traditional asset classes (See chart to the right). Bonds (represented by the 10-Yr Treasury on the chart) and gold (and other commodities) are always considered assets to allocate a portion of your portfolio or, even worse, a complete alternative to owning stocks.



With time on your side (i.e., 30+ years until you need your money), there is ZERO reason to allocate to these less than stellar assets. And if you are suggesting these non-stock assets will outperform stocks over the long run, take another look at the chart. Sure, gold and bonds may have their day in the sun in the short run, but not over a more extended period. The numbers do not lie.

As we all know, you don't take percentages to the bank… you take dollars. The chart to the right demonstrates the total return of a single $10,000 investment 35 years ago. Again, the stock market return is outrageous, but even more when you look at the outperformance over the other asset classes.



Put this another way… by investing in stocks, you have a lot of wiggle room (margin of safety, per se) NOT to achieve the 12.42% annual return and still be your best wealth-building investment (compared to these other traditional asset classes).

These days, the investment du jour is cryptocurrencies, non-fungible tokens (NFT's), and digital real estate within the metaverse. Unfortunately (or fortunately), these alternatives do not have enough history to add them to our chart above. Driven by a severe supply and demand imbalance and lack of clarity, these "investments" seem to be having their day in the sun. When will it end? Or will it ever end? We don't know, and many other people don't know.

We know that these alternative investments must produce at some point. We have no doubt some aspects of these cutting-edge technologies will be helpful to the majority of us in the future. The distributed ledger concept(s) (i.e., blockchain) of which Bitcoin is built will benefit many different aspects of life. And more importantly to us as investors, it will create profits.

But, Bitcoin (the most well-known crypto) might ultimately be remembered as a proving ground versus an actual useful currency. This is the point; we don't know. Nothing supports this as a solid investment. At this point, it is more speculative than anything else. As investors, we are more interested in focusing our attention on doing what we can to obtain that historical stock market return because, over time, it is unrivaled.

Onto the less apparent, but maybe more important reason to own stocks…

2) As A Shareholder, You Own Something (Which Should Give You Comfort)

Contrary to popular belief, the stock market is not a casino where gains & losses result from luck. It's also not a mechanism that can only rise so much before it must decline. On more than one occasion, We've heard, "Are we going to sell… the market is at all-time highs. It has to go down." Under this logic, we should always be selling (Ponder that for a minute). Newsflash… the stock market is designed to set new highs (We'll get to this later)!

It is easy (and understandable) for someone to be told about the stock market's historical returns and wonder why they should expect the same returns in the future. Hence, we are committing this valuable real estate to discuss what drives stock prices and these historical investment returns. To some, the below bullet points may be remedial, but even so, a good reminder of why we find such comfort in investing in the stock market.

- **Shareholders Are Owners:** When you buy a company's stock, you own a portion of that company. And just like being an owner of your own business, you share in the company's profits whose stock you purchased. Depending on the company, management will either reinvest these profits into their business or return them to shareholders via dividends or by buying back stock. All of these actions are designed to increase the value of your investment.

- **A Company's Market Value Is Supported:** A stock price results from taking a company's market value and dividing it by its outstanding shares. The market value is the critical number; it is the value that investors believe a company is worth on any given day. Typically, this value combines the company's current business plus the present value of future business expectations.

  Investors have different ways to value companies, but ultimately at the center of anyone's valuation will be how much money a company makes today and how much they will make in the future. Or put another way, how well does the company enrich its shareholders today and in the future. Yes, some companies have extended range plans that require years of capital investments before profits are expected, but ultimately your share of future profits is why you are investing. There is substance behind the stock price!

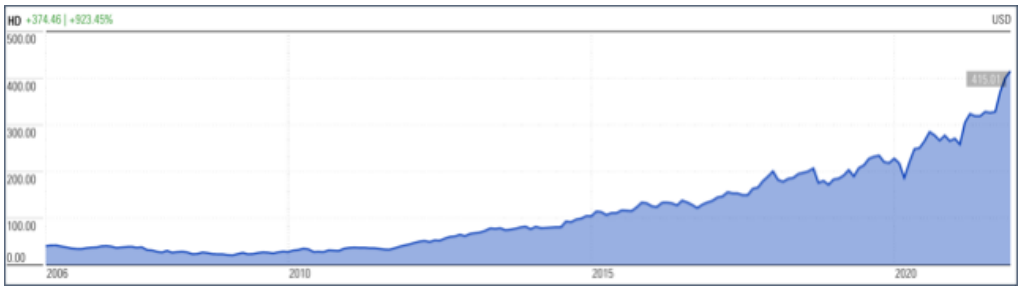
- **For Us, We Require Profits (And More**): For many investors, they are comfortable buying stocks of companies that do not earn a profit and may not for years. We are not those investors. In fact, not only do we require profits, but we expect the companies we invest in to add economic value (also known as Economic Value Added ("EVA")). For us, the EVA metric goes a step further in identifying companies that will stand the test of time… providing us even more confidence in the investments we make.

  EVA results from a company's return on capital vs. the cost of capital. So, let's say a company gets a loan of $100 at a 6% interest rate (this is the cost of capital). To create EVA, they must now deploy this $100 where their return (or profit) will be more than 6%. The company makes $10 in profit; they now have a return on capital of 10%. Compare this to the 6% cost of capital, and they have now created $4 of EVA.

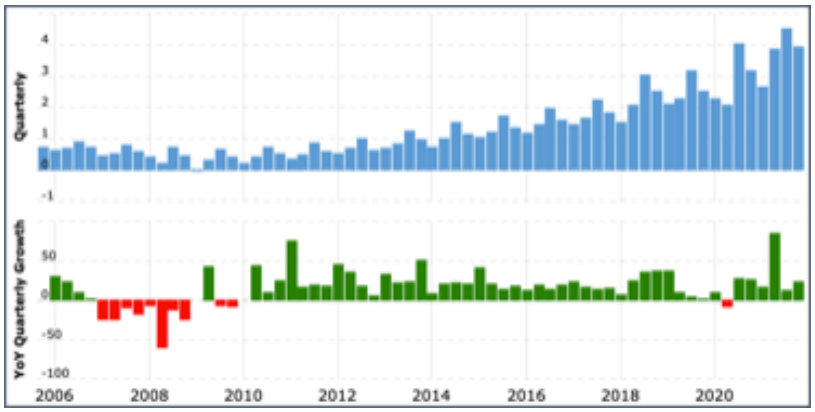
  This EVA metric has been a part of our investment analysis for 2+ decades. It helps us identify not only profitable companies but ones that we can rely on for the foreseeable future. Of course there are other attributes we need to see when identifying potential long-term investments, but EVA is at the core of our approach, giving us confidence and comfort in investing in companies via the stock market.

While nothing happens in lockstep (i.e., when earnings go up, that doesn't mean a stock price will go up commensurately), but over time, a stock price (market value) will accurately reflect the actual value of a company. Below are a few charts demonstrating this related to one of our long-standing investments... The Home Depot Company (HD).

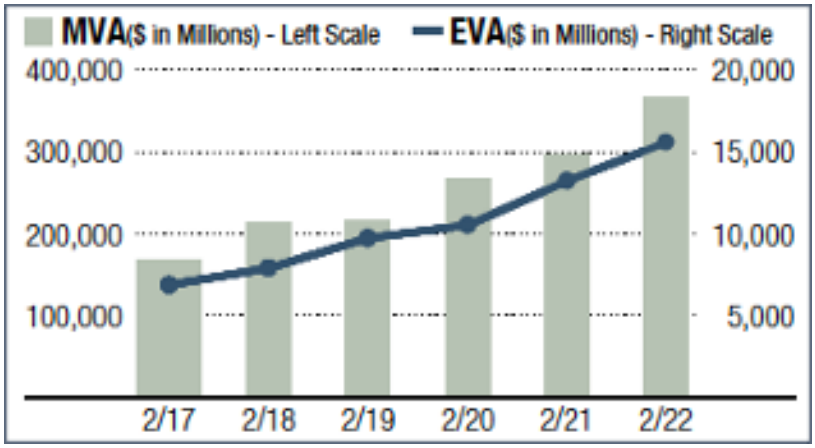
The below chart shows HD's stock price for the past 15 years. It has increased nearly 1,000% over this period. You'll notice its increase in value has not been a straight line. Even a company that is a duopoly (with Lowes) in an industry that most likely will be with us forever has seen corrections in its market value (i.e., stock price). But, ultimately, its stock price recovers over time because its profits support it.



To the right is a chart of HD's quarterly earnings. While there are pockets of weakness (i.e., during the great financial crisis of 2007/2008), over the long-term, profits exist and have generally increased with each passing year. More importantly, notice how the trajectory of the chart matches that of the stock price chart above. The stock chart would look quite different if HD did not have these continuously growing earnings.



As we mentioned above, we want profitable companies and want to invest in companies that produce EVA as it helps identify companies with staying power. Just as the quarterly earnings chart above moves with the stock price, so does this EVA chart to the right. As EVA increases, so does the stock price (on this chart, represented by MVA (Market Value Added)). Again, seeing this gives us comfort in HD's management making the suitable capital investments that will ultimately drive quality earnings and thus the stock price (market value).



In Summary… Just because there is something new doesn't mean the old no longer works. The math does not lie… the returns of the stock market are unmatched. More importantly, shareholders own something tangible. This is a powerful thought to remember, especially during periods of volatility.

There will always be new opportunities (investments du jours as we like to call them), but as investors (and investment advisors), we have real-world goals (i.e., retirement), and we see no reason not to use what we know, to achieve and exceed the goal of building a solid, diversified stock portfolio.

Over the past two decades, on our way to building wealth, we've experienced the highs and lows that stock market history told us we would. We have no reason to believe the next two decades will be any different.

We look forward to taking the journey with you!