Graves Light Lenhart
Build. Protect. Thrive.

January 19, 2022

# Graves Light Lenhart Q1'22 Client Newsletter

## Main Points:

- The financial markets experienced strong performance over Q4'21 (Dec. end) with the S&P 500 jumping 11%, helping to propel the full 2021 return to 28.7%. On the other side of the coin, equity valuations remain rich and inflationary pressures continue to surprise to the upside. However, we believe there are opportunities, especially in small-cap stocks.

- We reiterate our commitment to structuring our equity exposure to be meaningfully different than the S&P 500. We continue to emphasize value-oriented domestic stocks along with a meaningful allocation to international equities. In addition, we plan to take advantage of the unusually attractive valuation of small-cap stocks relative to large-caps. Higher interest rates, which we believe are sensitive to COVID related fears, could provide a much better relative environment for our portfolio positioning.

- Current projected equity market valuations based upon estimated earnings provide for an unusual environment where we are able to purchase similar to superior growth prospects for lower valuations (i.e. price per unit of earnings).

- Warren Buffett famously reminded participants that "if past history was all that is needed to play the game of money, the richest people would be librarians." This reinforces our determination to refrain from slavishly following the "play book". Nonetheless, we continue to believe that paying less for similarly situated assets ultimately provides for a superior investment experience. In summary, we are trying to marry our investment stance with the lessons of history along with the peculiarities of the present.

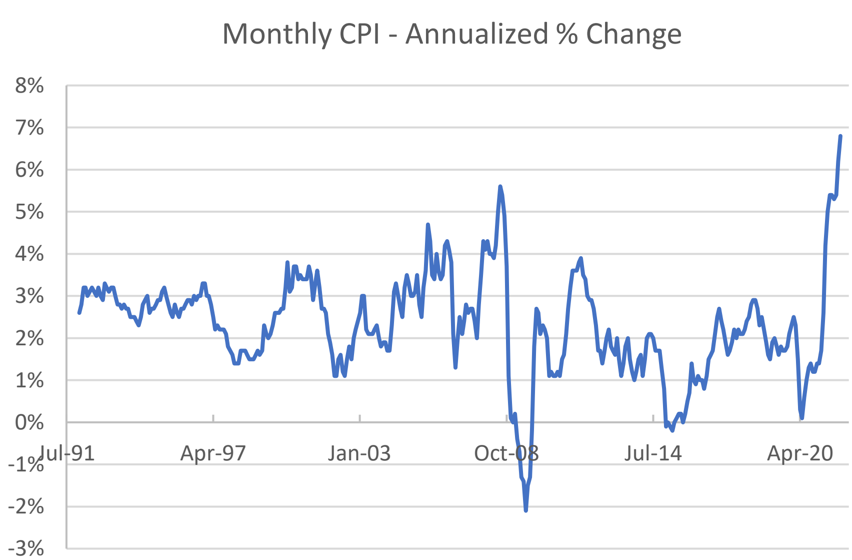
**“To suppose a stock’s value is determined purely by a corporation’s earnings discounted by the relevant interest rate is to forget that people have burned witches, gone to war on a whim, defended Stalin and believed Orson Welles when he told them Martians had landed.” —Jim Grant**

Q4’22 ended with a bang, which provided an interesting juxtaposition in comparison with Q3’21’s weak ending. We are encouraged that the equity market was able to fend off the concomitant heightened worries driven by the Omicron variant, which hit the market’s consciousness over the Thanksgiving holiday. Nonetheless, the S&P 500 rose an impressive 11% during the quarter overall with the S&P 500 Growth index increasing by 13.4% and the S&P 500 Value side of the market rising a distant, but still impressive, 8.3%. The U.S. equity market’s full year 2021 return was even more notable, if not surprising, with the S&P 500 jumping 28.7%. We can list many economic worries, but many market participants have not shared our reservations regarding market valuation, U.S. and Chinese debt overhangs, the potential demand pull-forward from seemingly unnaturally low interest rates, and a number of other concerns.

We continue to caution that market valuation levels provide very little “cushion” against changes in sentiment and/or the economic environment. Yet there are still opportunities, in our opinion. For decades, markets have enjoyed the tailwinds from steadily declining interest rates, which have likely come to an end. Historically, market environment changes lead to periods of increased volatility as investor psychology and positioning pivot to the new paradigm. Our message remains that we can’t control market movements, but we can maintain a disciplined approach to risk exposures, which plays a key role in portfolio efficiency.

## Economic Overview

Economic headlines have been largely focused on inflation for the fourth quarter of 2021 (October 1, 2021-December 31, 2021). This is hardly a surprise, as an annualized Consumer Price Index increase of 7.0% was recently reported for 2021, which is the highest reported value in several decades. As with most of the economic news of the past year and a half, the origin of the unusual readings lies with COVID. However, the root causes of inflation are a bit subtle. When COVID first struck in March of 2020, U.S. consumers retreated to their homes, were supported by government support programs, and saved at a rate higher than ever before seen. Such behavior was consistent with rational, precautionary savings given the great uncertainty of the pandemic. As a result of the

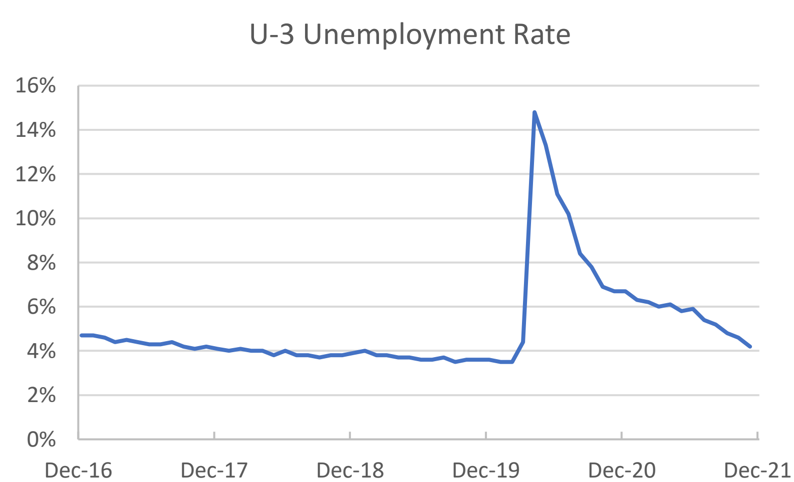


economic disruption, inflation dipped below zero. In fact, one of the predominant worries of that time was a potential fall into a deflationary spiral.

As consumers began to emerge from their homes, their spending patterns shifted from the pre-COVID services on which they'd previously spent money, to goods. Rather than hiring babysitters and taking vacations, they worked from home and bought patio furniture. Meanwhile, anticipating a recession, many factories had slowed production, or even shuttered as their workforce avoided or quarantined from COVID. Prices for goods began to increase. By mid-2021, inflation could be seen in clearly higher prices than in the locked-down times of early 2020. By late 2021, inflationary effects were widespread and notably higher than the pre-COVID environment.

Higher demand for goods leads to supply shortages of certain finished and unfinished products. Further, the labor force participation rate is still well below pre-pandemic levels and the headline unemployment rate is down to 3.9%, a rate very near "full employment." This provides upward pressure on wages, as employers must compete to a greater extent to hire from the limited pool of workers; the smaller than expected population of eligible workers actively seeking employment remains a mystery. As such, the dramatic pickup in inflation is due to the combination of COVID-related spending shifts, supply shortages, and increased wage demands. There remains debate on the likely length of this inflationary episode, with market participants and Fed officials alike appearing to be of the belief that a year or so of elevated inflation is likely.

Coincident with inflation, and clearly related, is the continued strong performance of the U.S. economy. 2021 proved very productive, with (annualized) real GDP up 6.3% in Q1, 6.7% in Q2 and 2.3% in Q3, the latest quarter available. The Q3 reading was negatively affected by the Delta variant of COVID, which has subsequently been displaced by the Omicron variant. Indications are that Omicron may be more contagious but milder than previous iterations of COVID, and therefore is likely a less negative drag on the momentum of economic growth. Correspondingly, the Atlanta Fed's GDPNow survey estimates Q4 real GDP growth of 5.0%.

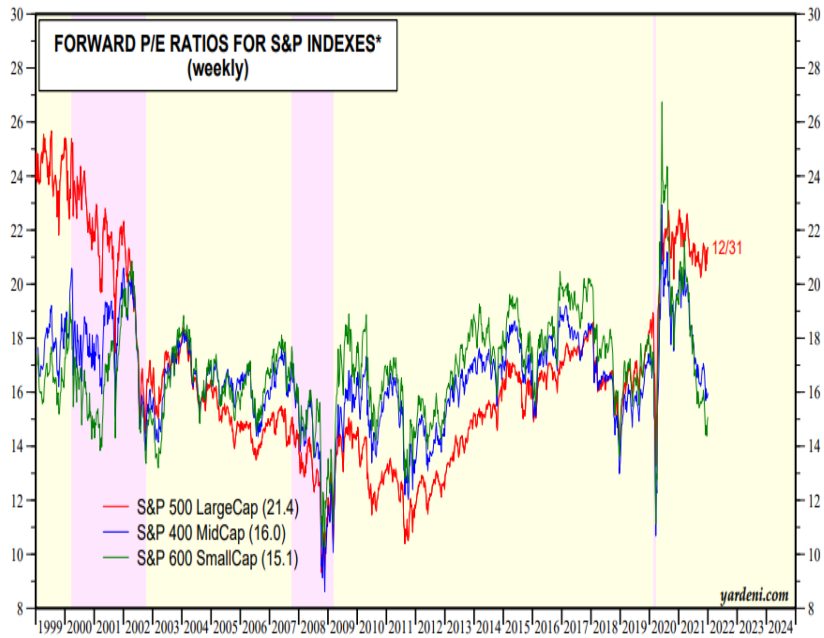



The unemployment rate has plummeted consistently since the April 2020 peak, reflecting the strong economy and the coincident demand for labor. The headline rate for unemployment dipped to 3.9% in December, the most recent data currently available. This is down from 6.7% in December of 2020 and in the "Natural Range of Unemployment" – a theoretical economic concept (abbreviated NAIRU) of the level of unemployment at which there is no "slack" in the labor market. Unemployment rates lower than NAIRU tend to contribute to inflation. That said, it is very difficult to precisely measure NAIRU, and it is often presented as an estimated range, in the neighborhood of 3.5%-4.5%. One interesting aspect of the current labor market has been the number of people opting out of participation altogether.

This is particularly true of workers more than fifty-five years old. If this segment of the population remains out of the labor force (and perhaps even if they don't), the labor market is expected to remain tight for some time.

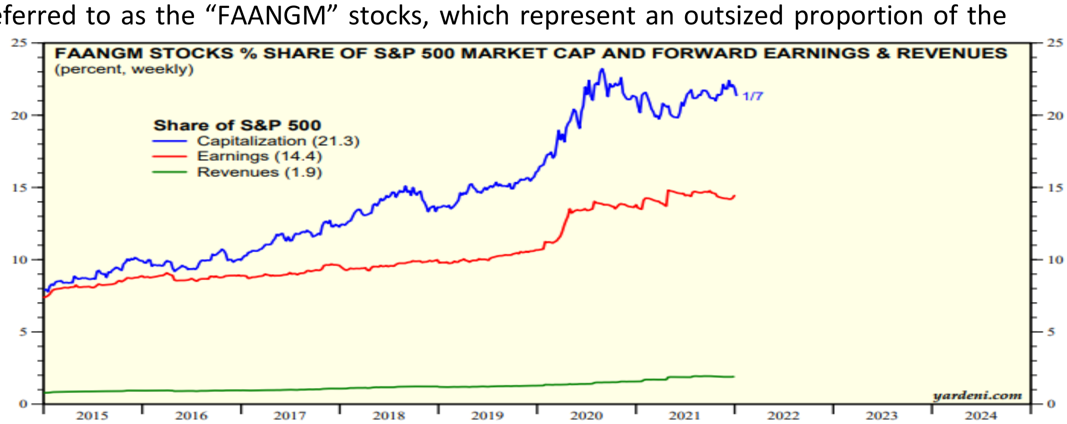
## Asset Allocation

Entering 2022, the investment landscape continues to show bifurcation both domestically and internationally. US assets, broadly speaking, trade rich (or expensive) to their long-term average valuations. However, when one looks beneath the surface there are indeed pockets of opportunity. There is a glaring valuation gap between small and mid-cap stocks, when they are compared to their large-cap brethren. Using 2021 year-end data, the graph to the right from Yardeni Research reveals the yawning valuation gap between large-cap stocks and the others. This is the widest these levels have been since the early 2000s. Solely focusing on valuation levels in isolation often proves futile in trying to *time* the market. However, using them as a "barometric guide" can help improve the risk/return investment potential over a full market cycle.




* Price divided by 52-week forward consensus expected operating earnings per share.
Note: Shaded red areas are S&P 500 bear market declines of 20% or more. Yellow areas show bull markets.
Source: I/B/E/S data by Refinitiv.

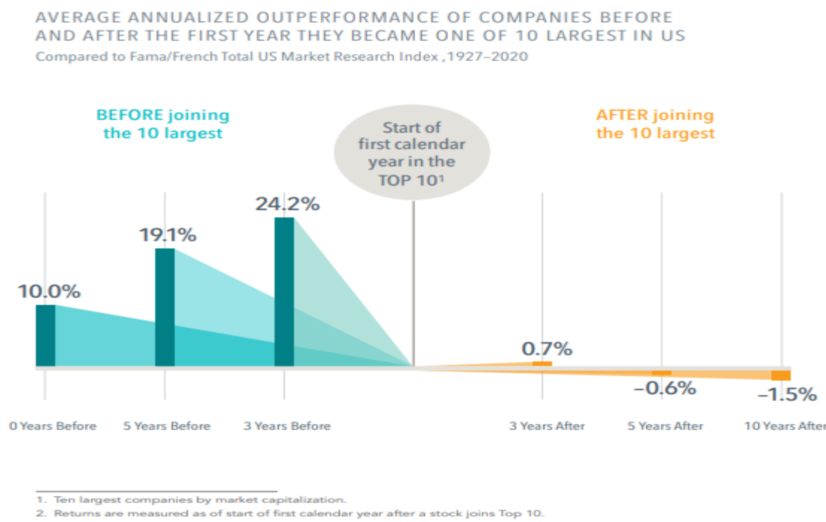
In parallel, there has been an increased focus from market participants on a small number of companies, often referred to as the "FAANGM" stocks, which represent an outsized proportion of the domestic stock market, especially in comparison to their fundamental impact (see chart).




* FANG stocks include Facebook, Amazon, Apple, Netflix, Google (Alphabet), and Microsoft.
Market cap includes both classes of Alphabet.
Source: I/B/E/S data by Refinitiv.

We have been chronicling the disproportionate influences that these stocks have had on the S&P 500 for quite some time. While the outcome for passive holders of the US stock market has been unequivocally lucrative as a result of FAANGM performance, valuation levels of these large constituents are disconcertingly high compared to the rest of the market. We continue to emphasize that this observed hegemony appears to be closely linked with the extensive liquidity injections provided by the Federal Reserve (GLL 4Q21 Newsletter). Conversely, the beneficiaries of these external market forces could become victims in the event of central bank tightening.

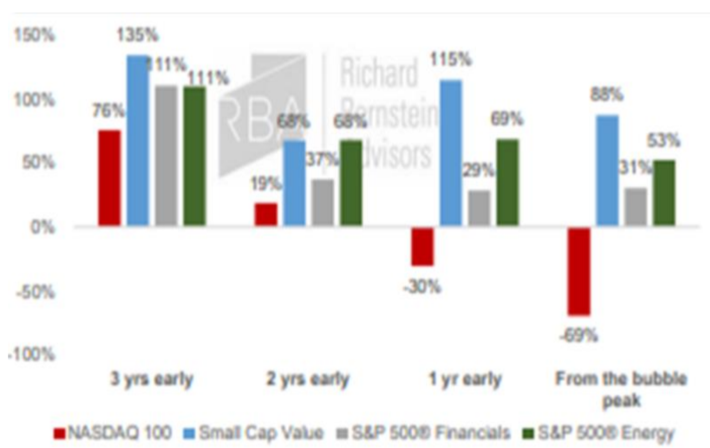
Further, history suggests that "top dog" performers seldom remain as such. According to Dimensional Research, from 1927 to 2020, the average annualized return for the Top 10 largest stocks (by market cap) was nearly 25% higher than the market over the three-year period prior to reaching their market leading position (see chart to the right). In the three years after they achieved that top-10 status, the edge was less than 1%. Five years after joining the Top 10, these stocks were, on average, underperforming the market. This gap widens even further after ten years.




*Source: DFA*

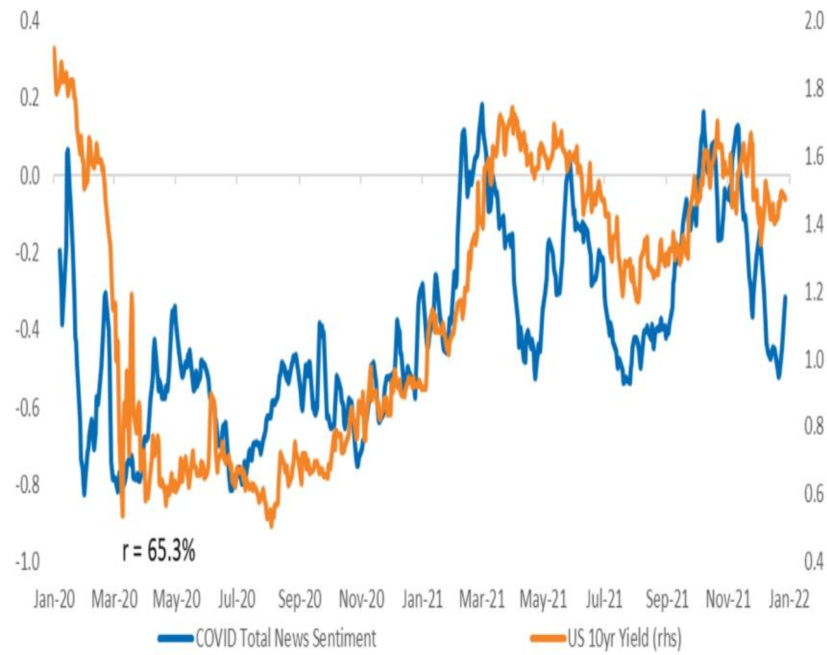
This underscores the importance of not blindly extrapolating future performance based on historical results. Strong past performance is by no means an indication of safety, yet it's a seemingly comfortable outcome which often lulls investors into a false sense of security. We adamantly seek to avoid this. Today's environment of high absolute market concentration coupled with skewed valuation levels reinforces our view that long-term portfolios should rotate away from mega-cap growth stocks where fundamentals appear to be largely uncoupled from intrinsic value.

Investors shouldn't underestimate the importance of being proactive with their portfolios when signals of froth are present in subsegments of the market. Using the 2000 dot-com analog to the right, one can observe that even if they shifted their portfolios away from the NASDAQ 100 three years earlier than the market peak, the opportunities were there to avoid the worst of the market's ensuing drawdown while still enjoying solid multi-year returns. In comparison, holders of the tech darlings of that period experienced sharp losses while riding such stocks through the entire cycle.



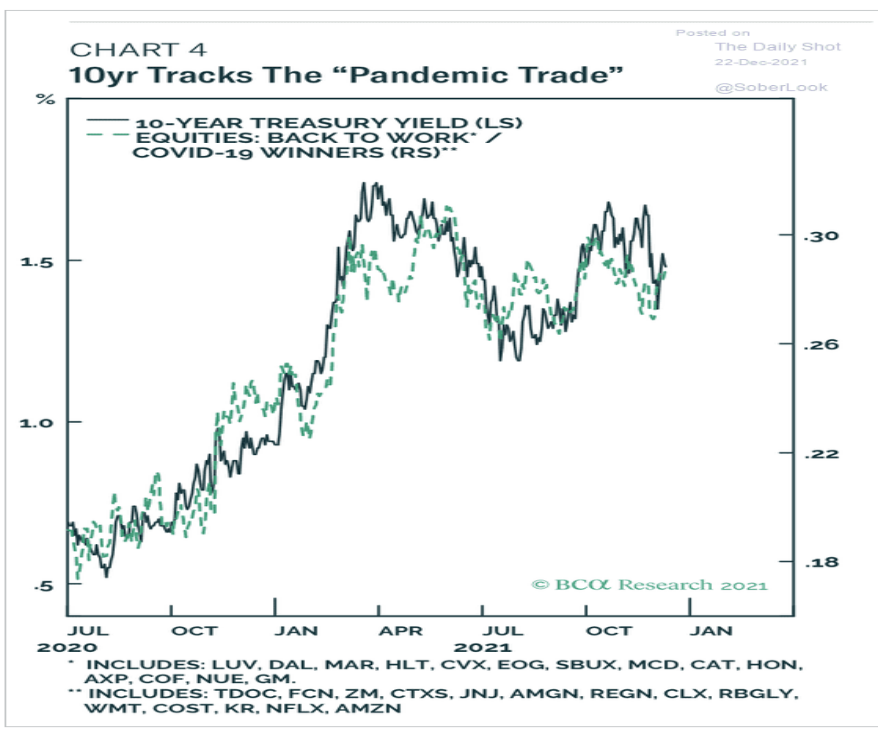

Source: Richard Bernstein Advisors LLC, Bloomberg
Note: all periods begin relative to 3/27/00 peak and end on 10/9/2004

Consistent with our previous recommendations, our current investment stance tilts towards value-oriented securities, small and mid-cap equities and shares of companies which would be seen as beneficiaries of a higher interest rate regime (e.g., financials). Much of this thesis is tethered to the evolution of the 10-Year US Treasury yield, as we continue to believe that this key rate should increase over time. However, the 10-Year Treasury Yield has remained stubbornly low despite the dramatic uptick in inflationary pressures, an effect that appears tied to COVID sentiment. This is illustrated in the graph to the right, implying many market participants continue to use the benchmark Treasury note primarily as a risk hedge, which has interrupted the 10-Year's market based reflection of both inflationary pressures and the real rate. Eventually, this relationship will be broken but, for now, we must recognize the anchoring nature that COVID fears have on interest rates, and by association, the equity market.




Source: Amenity, Bloomberg, 22V Research

If interest rates rise, we believe our equity portfolio positioning will benefit. As an illustrative proxy, we consider BCA Research's "Back To Work vs. COVID-19 Winners" index overlayed against the US 10-Year interest rate (right). While market relationships are rarely 1-for-1, we believe that as the US economy transitions towards more typical fundamental drivers, our portfolio positioning away from the large-cap growth dominated "COVID Winners" should benefit. At its core, we prefer to invest in businesses that are neither dependent on artificially low interest rates nor poor pandemic sentiment to buttress their valuations.




Source: BCA Research

Separately, we also favor international equities based both on relative valuation levels coupled with improving fundamentals. This will include some exposure to Emerging Markets, especially value-oriented securities. Not dissimilar to what we are observing in various subsegments of the US market, forward growth estimates for much of the developed international markets provide a favorable backdrop while paired with pedestrian valuations (see Factset data below). While valuations alone are not a catalyst, we see a combination of undemanding purchase multiples, improved earnings, and diversification benefits as key merits for portfolio inclusion. In essence, we are purchasing similar to superior growth prospects for lower valuations (i.e. price per unit of earnings).

| | | Earnings Growth Estimates | | |
|---|---|---|---|---|
| Index | Forward Price/Earnings | CY 2022 | CY 2023 | Blended Average |
| S&P 500 Growth | 26.6x | 6.9% | 10.4% | 8.7% |
| S&P 500 Value | 17.0x | 10.5% | 9.5% | 10.0% |
| S&P Mid-Caps | 15.5x | 8.2% | 7.8% | 8.0% |
| S&P Small-Caps | 14.6x | 17.9% | 14.4% | 16.2% |
| International (MSCI EAFE) | 15.3x | 7.8% | 7.1% | 7.5% |

*Factset Data as of 01/14/22

For fixed income allocations, increasing interest rates continue to be the biggest driver when deciding where to invest. While rates have rapidly adjusted to commence the year, we believe that we are still some ways off from appropriate yield levels as real rates remain deeply negative when accounting for both current and expected inflation. As interest rates continue to evolve, we prefer fixed income allocations to be representative of both higher quality securities and below-benchmark interest rate sensitivity.

## Closing Thoughts

The last two years have buffeted investors with an historically rapid equity market decline as the reality of the COVID threat and governmental responses set in. This was quickly followed by a remarkably strong bull market as governments around the world threw both the proverbial fiscal and monetary "kitchen sinks" at the COVID related shock. As such, seemingly broken historical relationships, ranging from valuation extremes to curiously low inflation premiums, have offered little guidance during the current cycle. However, governmental largess looks to be materially reigned in, given the impact of inflationary pressures. As such, we firmly believe that historical precedent will provide a useful analog for the next part of the market cycle. Warren Buffett famously reminded participants that "if past history was all that is needed to play the game of money, the richest people would be librarians." This reinforces our determination to refrain from slavishly following the "play book". Nonetheless, we continue to believe that paying less for similarly situated assets ultimately provides for a superior investment experience. In summary, we are trying to marry our investment stance with the lessons of history along with the peculiarities of the present.

Best regards,

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| Asa W. Graves VII, CFA | Jason Fink, PhD | Ash Heatwole, CFA |
| Chief Investment Officer | Director of Research | Portfolio Manager & Associate Director of Wealth Management |

*DISCLOSURE*

Stocks offer long-term growth potential but may fluctuate more and provide less current income than other investments. An investment in the stock market should be made with an understanding of the risks associated with common stocks, including market fluctuations. Stock dividends are not guaranteed. Investments primarily concentrated in one sector may be more volatile than those that diversify across many industry sectors and companies. The technology industry can be significantly affected by obsolescence, short product cycles, falling prices and profits, and competition from new market participants. Global/International investing involves risks not typically associated with US investing, including currency fluctuations, political instability, uncertain economic conditions, different accounting standards, and other risks not associated with domestic investments. Investments in emerging markets may be subject to additional volatility. Stocks of small and mid-cap companies may also be subject to greater risk than that of larger companies because they may lack the management expertise, financial resources, product diversification and competitive strengths to endure adverse economic conditions.

The value of fixed income securities will fluctuate with changes in interest rates, prepayment payment rates, exercise of call provisions, changes in the issuer's credit ratings, market conditions, and other variables such that they may be worth more or less than original cost if sold prior to maturity. There is also a risk that the issuer will be unable to make principal and/or interest payments. Although treasuries are considered free from credit risk they are subject to other types or risks. These risks include interest rate risk, which may cause the underlying value of the bond to fluctuate, and deflation risk, which may cause the principal to decline and treasury securities to underperform traditional securities.

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