Fourth Quarter 2020 Commentary

Impeachment. Riots. A global pandemic. Fires. Earthquakes. Record-level unemployment. Murder hornets. A contested election. The most creative horror movie writer would have had difficulty writing a script as dreadful as what actually transpired last year.

As if to further test everyone's mettle, the *annus horribilis* that was 2020 spilled over into the new year. As of this writing, more than 3,000 Americans are dying on average each day of COVID-19. That's more than died on 9/11. Every day. And to add insult to injury, on January 6th an angry mob—egged on by the President of the United States—stormed the Capitol, resulting in the deaths of five people. Not since the War of 1812, when the British marched through our nation's capital, had our Capitol fallen prey to insurgents.

Amidst all this chaos and misery, there was a glimmer of hope in the fight against the pandemic, as vaccines from Pfizer and Moderna were approved and have begun to be deployed. The stock market grabbed onto these hopeful headlines and leapt into record territory as the year came to a close. For the fourth quarter the S&P 500 returned 12.1%, while the Dow Jones Industrial Average advanced 10.7%. All major averages ended 2020 higher than where they started the tumultuous year.

All-Time Highs? Why?!

So, yes, there were those glimmers of good news, but many are asking if stocks really deserve to be at all-time highs. "Does the stock market not pay attention to the news at all? Doesn't it see that there are still millions of Americans either out of work or under-employed? Doesn't it understand that Congress is hardly doing anything to help ease the pain? Doesn't it realize that taxes will have to be raised to deal with the significant amount of debt that the country has incurred?"

We admit that we share some of the befuddlement in the preceding paragraph, but one thing we remind ourselves in confusing times such as these is that the stock market is a forward-looking entity. It does not base its valuations on what is happening today, but on what it thinks will happen three, six, twelve months into the future, or longer. The stock market is looking beyond these challenging times and imagining a world in which the vaccinations have been deployed, the political violence has faded away, and American life has more or less returned to normal.

One other thing to remember about market valuation is that it is always based on alternatives. That is, if investors were not putting their money into stocks and thereby driving their prices higher, where would that money be going? Our fully liquid FDIC-insured savings accounts are earning all of 0.50% per year as of right now. If we were willing to lock up our cash for 3 years, we could get a CD paying 0.65%. Or if we went to 5 years, we could earn 0.85%. A 10-year bond with the backing of the full faith and credit of the United States Treasury is currently yielding a smidgen above 1.00%, and investment grade corporate bonds are not earning much more than that.

So, yes, on the one hand the oft-quoted P/E ratio of the overall market is currently around 33, which is one of the highest levels it has ever been. But if you invert that and divide the Earnings of the market by its Price, you would then get an E/P ratio, otherwise known as the market's earnings yield. The inverse of a multiple of 33 is almost exactly 3%, and that's significantly higher than any of those alternative measures.

Also, remember that the stock market's P/E ratio has an inverse relationship to prevailing long-term interest rates. As Warren Buffett recently said, "Interest rates are like gravity in valuation. If interest rates are nothing, values can be almost infinite. If interest rates are extremely high, that's a huge gravitational pull on value."

Consider two hypotheticals: long-term investing in the stock market versus the bond market. Buying a 30-year bond from the U.S. government today will yield about 1.85%. Invert that number, and you see that the "P/E ratio" of the long bond is currently around 54. If you buy that bond, you will receive each year 1.85% of your initial principal, and then your principal will be returned to you at the end of the 30 years.

Conversely, if you buy an S&P 500 index fund with your money instead, you will pay a P/E ratio of around 33, and you will receive about 1.50% of your initial investment back in the first year in the form of a dividend. But American businesses grow. As their profits grow, their dividends grow too, and in a handful of years you would be receiving far more than 1.85% of your initial principal in annual dividends. Furthermore, at the end of the 30 years, your investment will have grown in value similar to the way the businesses you owned during that time frame grew. In short, a 30-year investment in stocks is a slam-dunk no-brainer when compared to a 30-year investment in bonds.

But I Don't Have 30 Years!

Yes, that example is over a longer time horizon than most of us have the luxury of considering. But even when the time frame is shrunk down to ten years, we believe the math is still a no-brainer. As the time horizon continues to shrink, we have to think more carefully about how to proceed.

Our normal counsel is to try to match up as well as possible your typical living expenses with your income. Then, if there are any anticipated one-time expenses coming up in the next five years (e.g., a new car, a wedding, college tuition bills), keep that amount in cash. Any capital left over after that exercise can be invested in the stock market. Yes, that investment will swing around wildly in value over the time that it's invested, but we believe that it's the best way to protect and grow one's hard-earned money against the inescapable ravages of inflation.

We Reserve the Right to Be Wrong in the Short-Term

Please keep in mind that all of the above is only true over the long-term. Anything can, and probably will, happen in the short-term. Markets fluctuate in the short-term. It's what they do. The willingness to stomach those ups and downs is the price of admission to be able to earn the high returns the stock market gives you over the long-term. For all we know, our portfolios may see a temporary decline in value in 2021 of 20% or more. And for all we know, the market may go up further still.

But the point is that we don't know what will happen in the short term. No one does. We invest your money and ours with our eyes focused firmly on the future. We believe the businesses we own will be larger and more profitable five years from now than they are currently, and we believe that the stock market will account for that in due time.

Conclusion

With interest rates where they are, and with the profits of our businesses where they are, for now we hold onto our investments. When those underlying facts change, we will strive to take the appropriate actions to account for them.

Thank you again for allowing us to serve as stewards of your capital. We look forward to our next report to you three months from now.

Sincerely,

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