Fourth Quarter 2021 Commentary

Three months ago, most investors were optimistic about finally putting the coronavirus pandemic in the rearview mirror. The Pfizer vaccine was soon to be approved for use in children as young as five, the supply chain worries from earlier in the year began to abate, and we were all behaving just a little more socially than we had been since early 2020.

Then came omicron.

The number of positive COVID cases due to this latest variant of the virus is now dwarfing the earlier peaks from 2020 and 2021. Thankfully, it appears to be less lethal than earlier strains, but due to its amazing contagiousness we have been seeing headlines lately that we have not seen for the past 18 months or so. A few college football bowls were canceled, professional sports teams are delaying games, and some schools are going virtual again. While the unemployment rate is one of the lowest it's ever been, the labor participation rate is still so low that businesses across the nation are having trouble keeping the lights on due to a lack of workers willing to put themselves in harm's way.

Given all that negativity and uncertainty, of course the stock market … *[checks notes]* … roared ahead to new all-time highs in the fourth quarter. The Dow Jones Industrial Average returned 7.9%, and the S&P 500 index posted a full 11.0%. Those are numbers we usually see over an entire calendar year, but no those are indeed the quarterly figures.

For the full year the S&P 500 closed at a record high on 70 unique occasions. That is, more than one-fourth of all trading days in 2021 ended at a level never before seen in history. Investors treated the year as one of economic recovery, leading the S&P 500 to rise 29% and the Dow 21%. Since its low point in late March 2020, the S&P 500 has more than doubled through the end of 2021.

It Takes a Strong Stomach

We often say that the price of entry into this theater in which our investment accounts continue to earn heady returns like those shown above is the ability to withstand the day-to-day, quarter-to-quarter, and sometimes even year-to-year volatility. This past year was no exception. Yes, the market did go up more than 20% over the course of the full twelve months. But January, September, and November each provided some thrilling dips in the roller coaster that was 2021. One of those two major market averages was down 2%, 5%, and 4% in those three months. If the other nine months had been flat, we would have been down 10% on the year.

Over the course of the last 20 years, the S&P 500 has experienced intra-year declines of at least 5% in 19 of those years. So no matter how big your account balance may be at any given time, you should always expect that it will be at least 5% lower than that at some other point that same calendar year. That's nearly a certainty.

Slightly better than a coin flip are the odds that the S&P would experience an intra-year decline of at least 10%. That happened in 12 of the last 20 years. And in 4 of the last 20 years the S&P pulled back from its recent yearly high point by at least 20%. Two other years were close to that cut-off with pullbacks of 19%, so let's call it about a 1-in-4 chance of that happening.

The bottom line is that the stock market, while primarily driven by economic and financial fundamentals, also rises and falls a good deal based on human emotion. Be ready for that.

And An Even Stronger Will

We'd like to delve a little deeper into the negative return we cited above for November 2021. That 4% decline was posted by the Dow Jones Industrial Average, which is a price-weighted index of 30 prominent American companies. The S&P 500, though, declined by less than 1% that month. And the Nasdaq Composite, a broad but tech-heavy index, was actually positive for the month of November. How can that be?

Well, both the S&P and the Nasdaq are capitalization-weighted, which means that the largest companies that comprise it account for the lion's share of the returns for the group as a whole. So if the largest three or four or five stocks in a big index all do well for a given time frame, and the hundreds of other stocks all suffer, the index overall can still post a relatively healthy number. We wrote about this phenomenon in 2015, when 5 companies accounted for more than 80% of the S&P's return that year, meaning the remaining 20% was created by the other 495.

In November 2021, some Nasdaq darlings suffered terrible declines: Paypal was down 21%, Zoom Video was down 23%, Roku 25%, Beyond Meat 29%, Teladoc 32%, Zillow 48%, and Peloton 52%. Yet the 100-stock Nasdaq Composite was actually in positive territory for the month. When the ten largest members of a stock index account for more than half of the aggregate market cap (which is exactly how Nasdaq is set up with Apple, Microsoft, Tesla, and others at the top of the list), it doesn't much matter what happens to a few of the other 90 stocks.

All of this is something to keep in mind, since your portfolio is not invested in market indexes. We select individual stocks for you to own over the long term. There can be a lot of noise in the stock market as the prices of so many stocks move around so wildly in such short time frames, sometimes in opposite directions, but we do our best to remain focused on the business fundamentals of the companies of which you are a part-owner.

Thank you again for allowing us to serve as fiduciaries of your hard-earned capital. We look forward to reporting to you again in the spring.

Sincerely,

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