KOVITZ INSIGHTS

Perspective for the Long Haul

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Christopher Quigley
SENIOR RESEARCH ANALYST

With our senses constantly bombarded by alluring stock market pitches for instant riches or by equally convincing warnings of impending doom, it is not easy to remove emotion from the investment process. History shows that suppression of emotion can smooth travels on the road to potential long-term investment success. No doubt, that's easier said than done and it takes a strong stomach to endure the ups and downs, especially this year.

We seek shelter from the chaos by holding fast to an investment philosophy that is built on a firm foundation of selection, diversification and patience. That last bit—patience—is perhaps most crucial, especially when market winds shift against us. It can help to know that market moves over the long term have been more often favorable than not.

A STRONG STOMACH

We understand that scary things often trigger emotional responses, but it is helpful to remember what legendary investor Peter Lynch, the former Portfolio Manager of the Fidelity Magellan Fund, had to say about becoming a great investor: "In the stock market, the most important organ is the stomach. It's not the brain. On the way to work, the amount of bad news you could hear is almost infinite now. So the question is: Can you take that? Do you really have faith that 10 years, 20 years, 30 years from now common stocks are the place to be? If you believe in that, you should have some money in equity funds. It's a question of what's your tolerance for pain. There will still be declines. It might be tomorrow. It might be a year from now. Who knows when it's going to happen? The question is: Are you ready—do you have the stomach for this?"

Similar words of wisdom were penned by Al Frank, the founder of Kovitz' *The Prudent Speculator* newsletter back in 1998, "As I struggle to maintain the tranquility and perspective of long-term investing, which has been a bit shaken by recent actions in the stock market, I hope you too can maintain the belief that 'this too shall pass away.' Life is pain and suffering as well as joy and triumph, but not necessarily in equal amounts. I think there are many who believe life is a hard struggle with intermittent periods of relief, while others believe that life is generally good with intermittent moments of trauma and darkness. Let us belong to the positive, optimistic class and not let the plethora of seemingly negative events, in the stock market and elsewhere, shake our faith in the good we now have."

Yet, despite the historical evidence that argues strongly for staying the course, investors often let near-term volatility drive what should be long-term allocation decisions, shortening holding periods and increasing the risk of loss. Schroders, the British multinational asset manager, reported in its *2019 Global Investor Study* that individual investors had an average holding period of 2.6 years, while 41% stayed invested for less that one year. In comparison the average holding period is 8.2 years for current holdings in the dividend-oriented Kovitz ValuePlus strategy, so it would seem that individual investors not working with a professional exhibit a profound lack of patience, which can adversely impact returns.

VOLATILITY IS VERY NORMAL

One of the secrets to successfully investing in stocks is to not get scared out of them. Certainly, it's the job of the financial media to trumpet market action in either direction, but we think it

exacerbates investor perception of market volatility. Prodded into believing that the market has encountered historically unusual volatility (or at least heightened volatility), investors are encouraged to make portfolio changes in fear of some potentially detrimental event lurking on the horizon. Yet predicting events that happen regularly is not a particularly challenging activity. As Figure 1 shows, market drops—represented by the S&P 500—happen frequently, with 5% losses occurring approximately three times per year over the past 95 years before an intervening gain of at least the same amount, while "Corrections" (10% drops) have occurred once per year and "Bear Markets" (20% drops) have occurred every three and a half years. We aren't suggesting that Corrections and Bear Markets are painless (they are not), but a lack of perspective related to the frequency of such events can adversely impact one's decisions.

Figure 1: Stock Market Volatility Is Not Rare

From 02.20.1928 through 10.31.2020. Price return series. We defined a declining market as an instance when stocks dropped the specified percentage or more without a recovery of equal magnitude, and an advancing market as an instance when stocks appreciated the specified percentage or more without a decline of equal magnitude. Source: Kovitz using data from Bloomberg Finance L.P.

Advancing (Bull) Markets						
Minimum Rise %	Average Gain	Average # Days	Count	Frequency (in Years)	Last Start	Last End
20.0%	109.1%	930	27	3.4	3/23/2020	9/2/2020
15.0%	66.8%	566	45	2.1	3/23/2020	9/2/2020
10.0%	34.9%	244	98	0.9	3/23/2020	9/2/2020
5.0%	14.8%	72	308	0.3	9/23/2020	10/12/2020
2.5%	7.8%	26	782	0.1	9/23/2020	10/12/2020

Declining (Bear) Markets						
Minimum Decline %	Average Loss	Average # Days	Count	Frequency (in Years)	Last Start	Last End
-20.0%	-35.4%	286	26	3.6	2/19/2020	3/23/2020
-15.0%	-28.4%	189	44	2.1	2/19/2020	3/23/2020
-10.0%	-19.6%	102	97	1.0	2/19/2020	3/23/2020
-5.0%	-10.9%	36	308	0.3	10/12/2020	10/31/2020
-2.5%	-6.5%	16	783	0.1	10/12/2020	10/31/2020

While there is no guarantee that past performance is indicative of future results, we do find it reassuring that every meaningful market drop has been followed by a gain of at least equal magnitude, and we are sure that those who bailed out of equities in favor of "safer" fixed income securities earlier this year are likely lamenting their moves, as the S&P 500 has already pushed above the February 19th all-time high thanks to big performance contributions from Apple, Amazon and Microsoft.

TRUMPETING LONG-TERM MARKET RETURNS

Near-term thinking can hamper long-term success and we think this is plainly evident when reviewing nearly a century of data. As Figure 2 dramatically illustrates, a heck of a lot more money would have accumulated over the past 95 years if $100 were invested in equities instead of fixed income, with small capitalization stocks outperforming their large capitalization peers. To get a sense of long-term returns, we added annualized returns to the right side of Figure 2, and we see that equities, both large and small, have handily outperformed short-, intermediate- and long-term government bonds.

While it is obvious that stocks have offered the best returns, the natural question is which types of equities have enjoyed the greatest performance? Professor and Nobel laureate Eugene Fama and Professor Ken French provide historical answers for that as well, which we show in Figure 3. Using the ratio of book value to share price (higher = Value and lower = Growth) as the distinguishing factor, we see that common sense prevails, as fundamentally less expensive stocks have performed better. Figure 3 also shows this phenomenon holds regardless of market capitalization, with small value and large value stocks actually outperforming small growth and large growth companies.

Figure 2: Long-Term Performance

From 06.30.1927 through 09.30.2020. Logarithmic scale. SOURCE: SOURCE: Kovitz using data from Morningstar

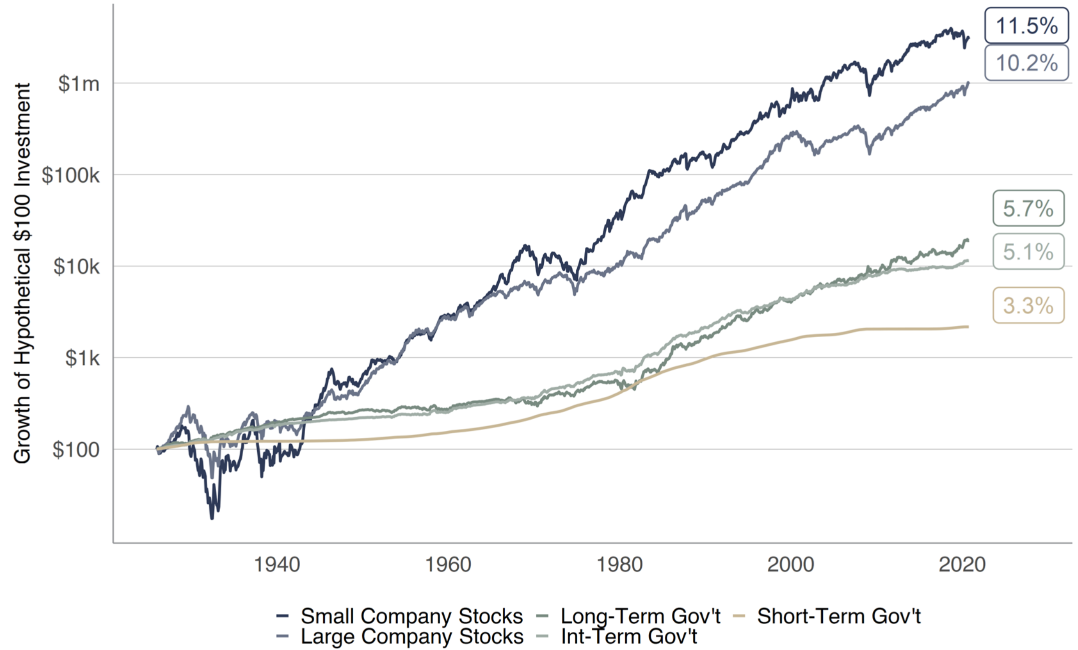

Figure 3: Fama-French Value versus Growth

From 06.30.1926 through 09.30.2020. Logarithmic scale. SOURCE: Kovitz using data from Professors Eugene F. Fama and Kenneth R. French

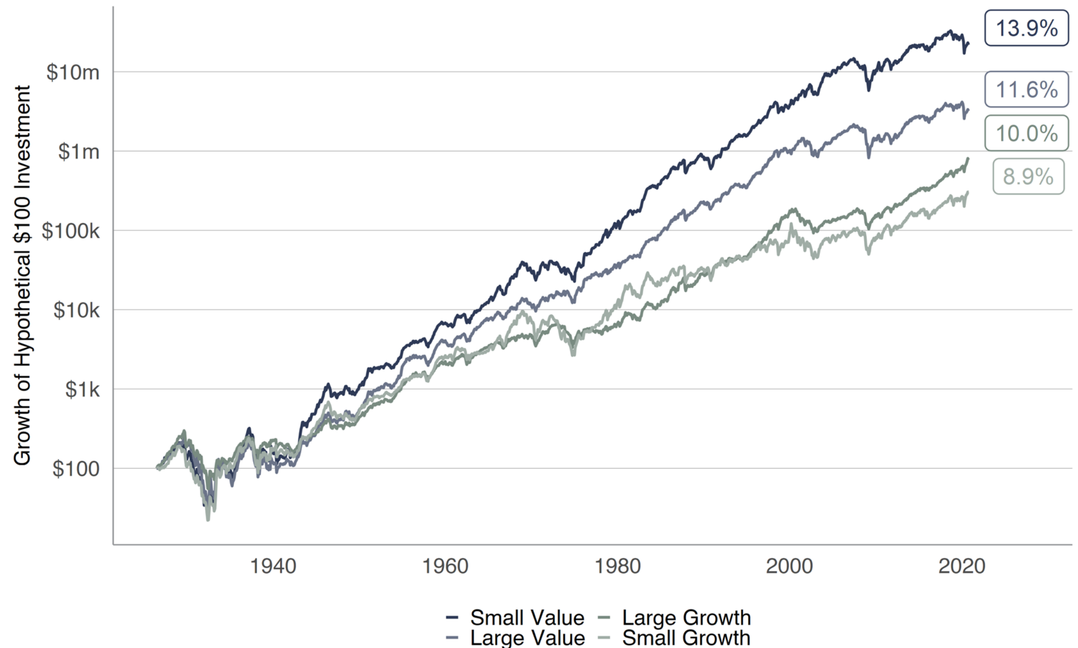

Figure 4 illustrates the wonders of compound annual returns. If money is allowed to compound at the 10.2 percent return that Morningstar posted for Large Company stocks from December 31, 1925 through September 30, 2020, it would double every 7.1 years, offering the potential to methodically grow wealth in exchange for staying invested during the trials and tribulations along the way. If compared to the 'Rule of 72', it would take 72,000 years (72÷0.01) for money to double at the current money-market yield of 0.01 percent, as reported by Schwab's Government Money Market Fund (SNVXX) on October 31.

Figure 4: The Miracle of Compounding

From 12.31.1925 through 09.30.2020. This table illustrates the performance of a hypothetical $100 investment made in the asset class noted on 12.31.1925. It assumes the reinvestment of dividends and and capital gains. SOURCE: Kovitz using data from Morningstar

Growth of $100 Invested in Each Asset Class on 12.31.1925					
Date	Large Company Stocks	Small Company Stocks	Short-Term Gov't Bonds	Intermediate-Term Gov't Bonds	Long-Term Gov't Bonds
12/31/1925	$100	$100	$100	$100	$100
12/31/1940	$181	$90	$122	$190	$208
12/31/1960	$2,845	$2,882	$157	$282	$304
12/31/1980	$14,051	$52,399	$459	$726	$507
12/31/1990	$51,750	$127,745	$1,043	$2,362	$1,839
12/31/2000	$258,634	$640,223	$1,656	$4,859	$4,886
12/31/2010	$297,614	$1,605,470	$2,055	$8,412	$9,294
9/30/2020	$974,191	$3,024,246	$2,171	$11,471	$19,068

In our Value strategies, we hold stocks for the long term, beginning with our individual stock valuations, which look out 3-to-5-years. We are confident that the lengthy holding period increases the likelihood of positive long-term returns and we also believe that it reduces our risk. Figure 5 supports the merits of long-term investing.

We reviewed data provided by Morningstar regarding the performance of Large Company stocks from December 31, 1925 through September 30, 2020 and found that the risk of losing money in any one year was 24.5 percent. The risk of loss dropped to 12.1 percent if stocks were held for 5 years, 5.2 percent if they were held for 10 years and 0 percent if held for 20 years or more. Small Company stocks have shown the same trend over the long haul, while the batting average over the near term slightly trails Large Company stocks.

Figure 5: In for the Long Haul: Patience is Virtuous

From 12.31.1925 through 09.30.2020. Source: Kovitz using data from Morningstar

Investment Success by Rolling Windows								
Rolling Window	Large-Company Positive Return Count	Large-Company Negative Return Count	Large-Company Percent Positive	Large-Company Percent Negative	Small Company Positive Return Count	Small Company Negative Return Count	Small Company Percent Positive	Small Company Percent Negative
1 Month	714	423	62.8%	37.2%	694	443	61.0%	39.0%
3 Months	779	356	68.6%	31.4%	720	415	63.4%	36.6%
6 Months	809	323	71.5%	28.5%	757	375	66.9%	33.1%
1 Year	850	276	75.5%	24.5%	810	316	71.9%	28.1%
3 Years	926	176	84.0%	16.0%	916	186	83.1%	16.9%
5 Years	948	130	87.9%	12.1%	944	134	87.6%	12.4%
10 Years	965	53	94.8%	5.2%	990	28	97.2%	2.8%
15 Years	956	2	99.8%	0.2%	939	19	98.0%	2.0%
20 Years	898	0	100.0%	0.0%	898	0	100.0%	0.0%

CLOSING THE LOOP

Historical stock market data would suggest that the past year has actually been fairly normal, with the exception of the speed of the S&P 500 index's decline and bounce-back caused by the COVID-19 pandemic's rapid spread. Though there are therapies in the works, there are few signs that the virus is suddenly going to disappear on its own and investor uncertainty in the last quarter of 2020 is likely to be amped up by the contentious nature of the U.S. Presidential Election.

We know that no matter what the historical evidence supports, many investors will shun equities due to worries over partisan disagreements, low energy prices, high gold prices, inflation, slowing corporate profits, geopolitical uncertainty and/or interest rate uncertainty. These are certainly valid concerns, but they are no worse than what we have faced in the recent past. Reason tells us that equity investing is the way to go and that our Value-oriented strategies work, therefore we won't be deterred by emotional headlines.

Even more, our long-term track record is not the result of frenetic adaptation to constantly changing investment fads and fashions. Through the years, we have remained steadfast in our commitment to what we view as undervalued and out of favor stocks, and our holdings, on average, have consistently sported high book-value-to-price ratios and pay dividends (a topic we reviewed in our October 2020 Insight). Indeed, relying on what has worked historically is the foundation of everything we do. Still, we must have learned a thing or two about stock selection over the years as well.

For more information on working with our financial professionals contact us at wealth@kovitz.com or 312.334.7300.

DISCLOSURES

Definition of the Firm: Kovitz Investment Group Partners, LLC (Kovitz) is an investment adviser registered under the Investment Advisers Act of 1940 that provides investment management services to individual and institutional clients. From October 1, 2003 to December 31, 2015, the Firm was defined as Kovitz Investment Group, LLC. Effective January 1, 2016, Kovitz Investment Group, LLC underwent an organizational change and all persons responsible for portfolio management became employees of Kovitz. From January 1, 1997 to September 30, 2003, all persons responsible for portfolio management comprised the Kovitz Group, an independent division of Rothschild Investment Corp (Rothschild).

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The description of products, services, and performance results contained herein is not an offering or a solicitation of any kind. Past performance is not an indication of future results. Securities investments are subject to risk and may lose value.

All returns are geometric average unless otherwise stated. The geometric average is calculated using the mean of a set of products that takes into account the effects of compounding.

The federal funds rate is the rate banks charge on loans to each other.

The quoted forward yield for the S&P 500 uses the iShares S&P 500 ETF (ticker: SPY) as a proxy. The quoted forward yield for the S&P Core Value uses iShares Core S&P U.S. Value ETF (ticker: IUSV) as a proxy. The quoted forward yield for the S&P Core Growth uses iShares Core S&P U.S. Growth ETF (ticker: IUSG) as a proxy.

The factor-based (book value-to-price) portfolio data is from Eugene F. Fama and Kenneth R. French. The dataset is broken into four groups: large value, large growth, small value and small growth. The aggregate Value and Growth portfolios are monthly averages of the two returns.

The Standard & Poors 500 index (S&P 500) is a broad stock market index based on the market capitalizations of the largest 500 companies listed in the U.S. Small company stocks, via Ibbotson Associates, are the bottom twenty percent of the New York Stock Exchange. Large company stocks, via Ibbotson Associates, are represented by the S&P 500 index. The S&P 500 Growth Index is a market capitalization weighted index. All the stocks in the underlying parent index are allocated into value or growth. Stocks that do not have pure value or pure growth characteristics have their market caps distributed between the value & growth indices. Prior to 12/19/2005 this index represented the S&P 500/Barra Growth Index. The S&P 500 Value Index is a market capitalization weighted index. All the stocks in the underlying parent index are allocated into value or growth. Stocks that do not have pure value or pure growth characteristics have their market caps distributed between the value & growth indices. Prior to 12/19/2005 this index represented the S&P 500/Barra Value Index.

From 1927 to present, we utilized the dividend-weighted portfolio data from Eugene F. Fama and Kenneth R. French. The dataset is broken into five groups: non-dividend paying, top 30% of dividend payers, middle 40% of dividend payers, bottom 30% of dividend payers and all dividend payers (weighted 30% of top dividend payers, 40% of middle dividend payers and 30% of low dividend payers).

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