Warnke/Nichols Ltd.
Investment Management

William R. Warnke, CFA
Steven R. Nichols, CFA

PORTFOLIO NOTES **JANUARY 2022**

To our Business Partners:

- ***A WEIGHT PROBLEM.*** No, we're not talking about the inevitable result of bingeing on food and drink over the holidays and finally stepping on the scale. What we're referring to is the current stock market's overweightness. Most market indexes are weighted by the size (market value) of the companies making up the index. So, the largest companies have the most influence on their index. Currently, the top 10 companies in the S&P 500 comprise about 34% of the index's total value. In other words, 2% of the companies in the index represent over one-third of its total value! Incredibly, a 1% gain in the market capitalization of those 10 companies has the same influence as a 1% gain *in the other 98% of the companies in the S&P 500*.

  While this has always been a problem throughout market cycles, it has been exacerbated in recent years by the growing influence of passive investing, and particularly in the growing popularity of Exchange-Traded Funds (ETFs). (*Passive investing* is the (somewhat mindless) purchase of a group of managed funds.) Like index funds, ETFs are designed to mimic an index, market sector, or industry. As investors have piled into these vehicles, which unlike a mutual fund can be traded freely on a stock exchange, the shares of the underlying companies must be bought to meet demand. As many ETFs are structured to own the best performing stocks, the increasing influence of those stocks becomes self-fulfilling, either on the upside or the downside.

  There are two final issues with this phenomenon. The action in the heavily weighted stocks obscures what's really going on in the markets. In the more speculative NASDAQ Composite, for example, which has the same weighting problem and is close to all-time highs, 40% of the stocks in that index are now *down 50% or more from their all-time highs*. The last time this happened was 1999, mere months before the crash in tech stocks.

  Finally, liquidity (the ease of buying or selling) will be a serious issue among ETFs. The same heavily weighted stocks are owned by many ETFs, which has boosted upside performance and given the illusion of stability. It'll surely also be a source of potential future instability. With so many ETFs and many other funds owning the same stocks, an extended period of market weakness (like 2000-03) could cause major liquidity issues with many trying to "exit the narrow doorway" at the same time. Suddenly those "passive" investors may not be so passive anymore!

  PORTFOLIO VALUATION. The aggregate price to intrinsic value of our portfolio companies* is now an unprecedented 104%. There *will* be a time again when we'll be able to buy a dollar's worth of a company for 60-70 cents, BUT there needs to be a significant markdown in prices for that to happen. Perhaps the last couple weeks of market weakness is the beginning.

- ***RECENT RESULTS.*** Stock market indexes rebounded in December after the declines of November. Most indexes rose 4-5%, except the tech-heavy NASDAQ Composite, which barely eked out a gain. For the year as a whole, indexes gained from 14-27%, with no clear advantage by company size. Our group* of portfolio stocks compare favorably with the market indexes over the same periods, scoring very satisfactory gains.

Steve Nichols, CFA *Bill Warnke, CFA*

The group of "portfolio stocks" -- our Equity Composite for the purpose of evaluating investment performance -- consists of 18 stocks that are held in our clients' accounts. Portfolios might hold some or all of these stocks, depending on investment guidelines unique to each client, the timing of purchases and sales, and start dates of accounts. The performance of this group of stocks is a good proxy for our equity performance but might vary widely among accounts. Of course, past performance is not necessarily indicative of future results.

We hereby offer to deliver to you without charge a copy of our current Form ADV Part 2, in accordance with the U.S. Securities and Exchange Commission's "Brochure Rule." Please contact us if you would like us to send you a copy.

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440 Wells Street, Suite 203 Delafield, WI 53018 262–303–4113
Fax: 262–400-3030 E-mail: value@warnkenichols.com www.warnkenichols.com