Warnke/Nichols Ltd. Investment Management
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PORTFOLIO NOTES **AUGUST 2022**

To our Business Partners:

- ***STEALING FROM THE FUTURE.*** The ten years through the end of last year produced compounded annual investment returns well above the long-term average and is among the highest produced in modern times. In looking at the components of return, these annual returns of over 16% annually were accomplished with above-average earnings growth of 8.5%, a dividend yield of 2%, and earnings multiple (price/earnings ratio) expansion of 6%. Simply adding the components together gives you a close idea of where the returns are coming from.

  Looking forward, dividend yields are still around 2%, and earnings growth is expected to moderate back to its long-term average of 5-6%, as companies face increasing pressure on their profitability. This leaves the change in the multiplier of earnings – the PE ratio. Over time, this factor has been fairly close to zero. So, with history as a guide, the estimate of future stock returns would be earnings growth of 5-6% + dividend yield of 2% + 0% PE change = 7-8%. However, periods of significant PE multiple expansion have often been followed by PE multiple CONTRACTION of roughly 3% annually. If so, one can expect even LOWER future stock returns in the range of 4-5% annually (5-6% earnings growth + 2% dividend yield – 3% PE).

  Most investors seem to be ignoring this historical mathematic probability of (1) a return to average earnings growth, (2) little or no increase in dividends and (3) price-earnings multipliers going DOWN. While there are usually many positive factors that go into significant multiple expansion, this usually comes at a price, in that future returns are negatively affected, as multiple contraction inevitably follows.

  Another economic factor getting little attention is that of the stock market and corporate profitability. Long-term, stocks cannot produce returns that are higher than the returns of the companies themselves. While companies have had the wind at their backs due to rising profitability over the last several years, that may be ending. We reckon that long-term corporate growth will gravitate back to historical averages and perhaps below, suggesting a more difficult environment for stock market returns in general.

  While we don't buy "the market," this does suggest that the investing environment will be more difficult in the coming months, but more new opportunities will present themselves as stock prices adjust to more rational valuation levels.

- ***PORTFOLIO VALUATION.*** The recent rally in the stock market has taken our group of portfolio stocks* up to 83% of value, suggesting less-than-hoped-for future returns, somewhat like the expected market returns described above. We're waiting for markdowns in prices before becoming more active "shoppers."

- ***RECENT RESULTS.*** Stock market indexes staged a significant comeback after the declines from the January peak. Advances ranged from about 7% for the Dow Jones Industrials to over 12% for the NASDAQ Composite. Those indexes which suffered the largest declines in June generally posted the largest rebounds in July. Year-to-date returns are still negative, with the NASDAQ down 20% and the Dow showing a decline of just under 10%. Other indexes we monitor are down 11-16%. For the trailing twelve months, declines range from 6-15%. Our group of portfolio stocks* continue to compare favorably to the averages over all three periods discussed above.

Steve Nichols, CFA *Bill Warnke, CFA* *Andy Ramer, CFA*

****The group of "portfolio stocks" -- our Equity Composite for the purpose of evaluating investment performance -- consists of 19 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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