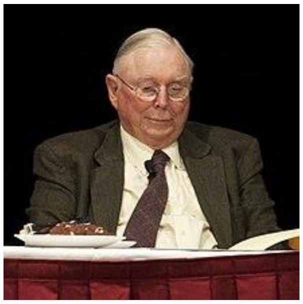
January 10th, 2024

Winter Quarterly Commentary



"Understanding both the power of compound interest and the difficulty of getting it is the heart and soul of understanding a lot of things."

Charlie Munger (1924-2023)
Investor and philanthropist
Vice-Chairman of Berkshire Hathaway

The end of the year is a natural time to look back and reflect on recent events. Certainly, it was a good year to be invested in the stock market. The S&P 500 Index returned a stunning 26.3%, ending the year in spitting distance of all-time highs. However, we'd like to look back further than January 2023. It occurred to us that with this letter we've been writing these missives for 30 years. You hold in your hands our 120th release[1]! You can find them all on our new website: www.knightsb.com/insights.

At such an auspicious anniversary, we thought it appropriate to take a break from our usual economic analysis and instead zoom out to deliver a bird's eye view primer on investing in the stock market and what to expect[2]. We will also answer the question, "Is this a good time to invest in the stock market?". However, we are going to make you stay with us to the end to get the goods on that one.

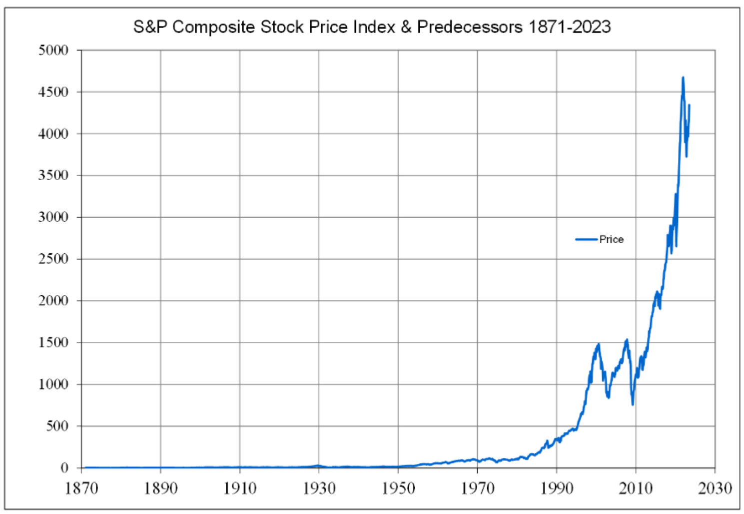
[1] Technically, twice we were interviewed and published the transcript instead.

[2] We will necessarily have to simplify but we hope the reader comes away with a grasp of the big important ideas.

During the 30 years we've been writing these letters, the S&P 500 Index has returned 1,789.3%, with dividends reinvested. That means U.S. investors by and large made eighteen times their money over this period. Our flagship equity strategy seeks to do even better than the market, and we've been reasonably successful in delivering that outcome. However, generally the most important thing is not whether you beat the market, ***it's if you are in the market at all*****.**

The most elementary thing to remember about the stock market is that ***it goes both up and down... but mostly it goes up*****[3]. This is a simple but powerful observation that can go a long way toward securing investment success if taken to heart. During periods of market duress, reinforcing this tenet becomes a large part of our job.**

Below is a long-term chart of the S&P 500 and its predecessors all the way back to 1871. You can see that the long-term gains have been huge: the first entry is 4.44 and the last on this graph is 4,516[4]. When you zoom out, it almost seems like in recent years the market has been going straight up without any pullbacks.



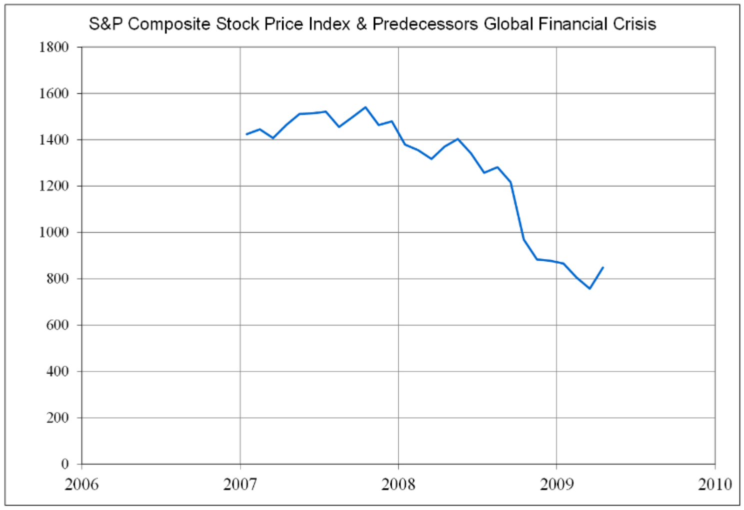
Unfortunately, this zoomed out experience is only available to the immortal or perhaps those who forget the password to their online brokerage account[5]. For us mere mortals, we experience life in something

[3] It's actually much better to say the market *has* gone up and down, but mostly it *has* gone up. Investing, like history, is a fundamentally human endeavor. We can study the past and extrapolate into the future, but the market, like the human behavior of which it is a reflection, is subject to change.

[4] As we go to print the S&P 500 index is at 4,757. The graphs show price change only and do not take the effects of inflation or dividends into account. Thanks to Yale professor Robert Shiller for publicly posting this data.

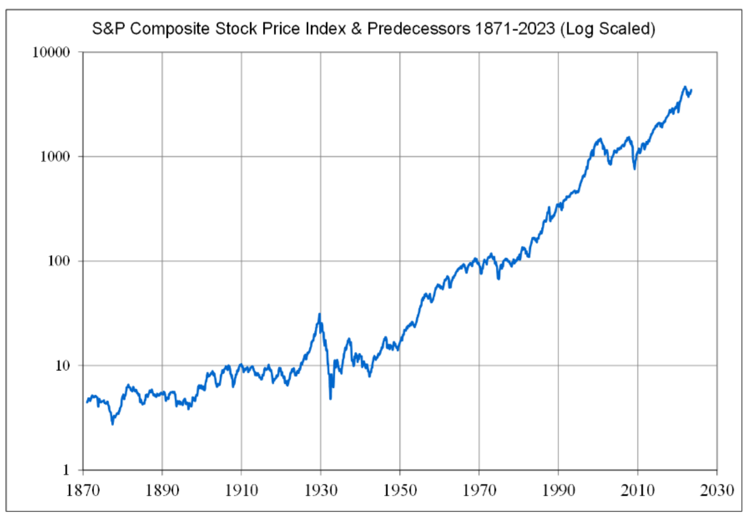
[5] Amusingly at least one study indicated that some of the top performing individual investor accounts were owned by people who had forgotten about them... assuming the account was invested before being forgotten. Sitting in cash for many years would be a sad thing indeed, as we will show further on.

closer to the zoomed in version of the chart below, which shows the gut-wrenching ~50% plunge during the Global Financial Crisis.



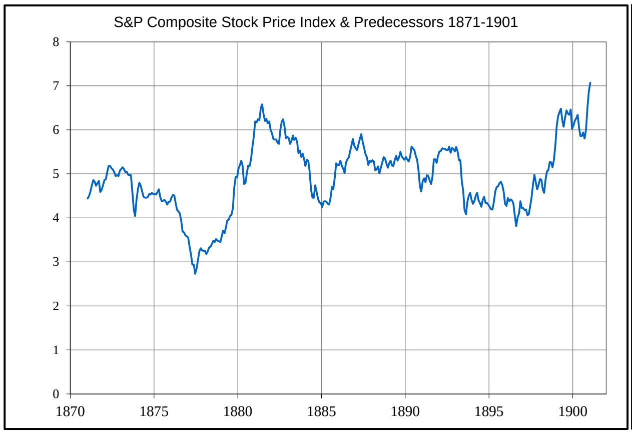
No one wants to see their investment portfolio sawed in half. But remember, when you put an occasional, large decline in the context of being a long-term investor, the impact of these seemingly staggering plunges melts away. After all, can you even locate the 1929 stock market crash preceding the Great Depression on the first chart? The difficult reality is that you have to live through periods of severe market crashes in order to reap the staggering benefits of being a long-term investor.

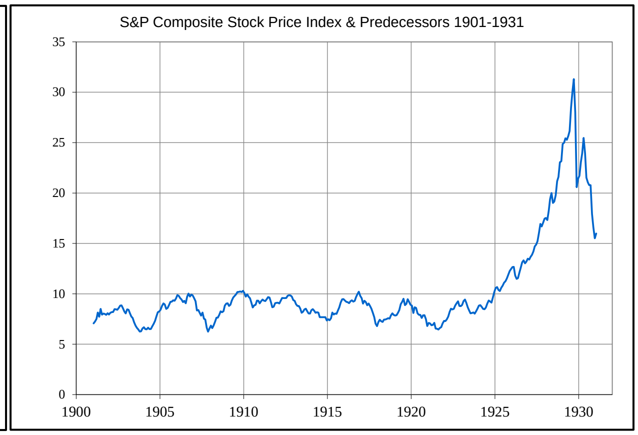
When we look at longer-term charts, we prefer them to be in logarithmic scale. On a standard linear scale, constant percentage growth will eventually appear parabolic, a curved up—and-to-the-right swoosh. However, it will appear as a straight line on a logarithmic scale. Here is the same full period S&P data on such a logarithmic scale.

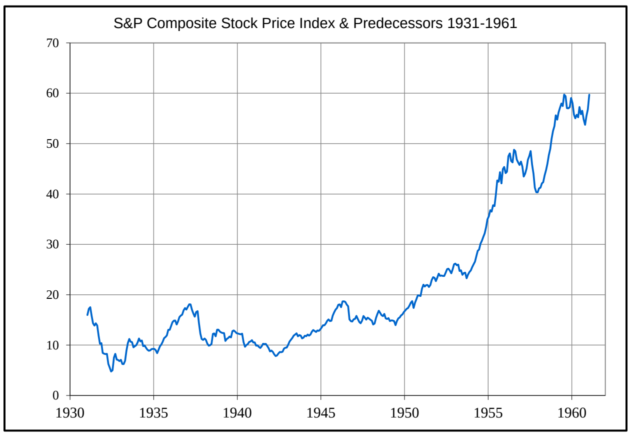


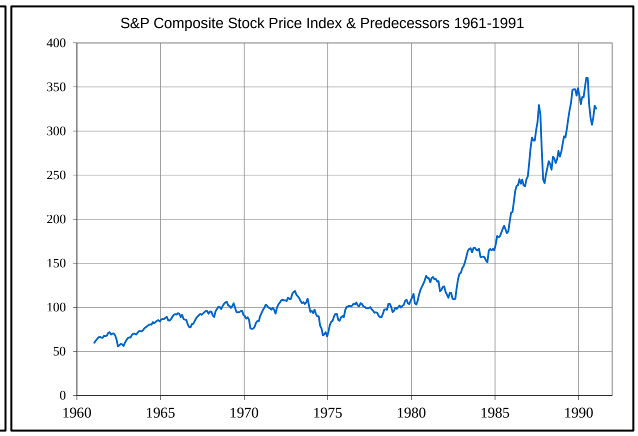
The graph looks reasonably straight, indicating that the stock market has grown at something close to a constant percentage rate over the longer term (though perhaps at an increased rate after 1940). In fact, when we go back and look at 30-year periods of U.S. stock market history on a linear scale, we see the same characteristic curved-up-and-to-the-right shape that we did on the full period graph in every period. This indicates that compound percentage growth is always working behind the scenes.

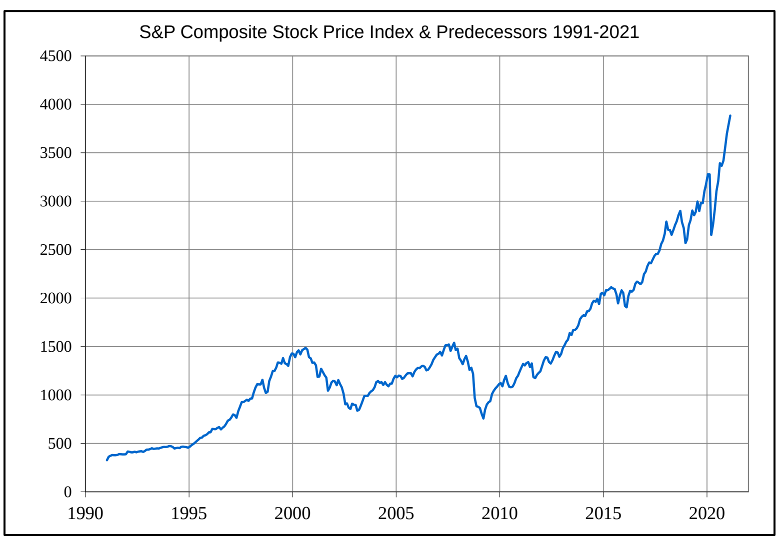
THE S&P 500 OVER DIFFERENT 30-YEAR PERIODS











But why should the stock market produce gains over the longer term at a relatively stable pace and in every period? A stock represents a share of ownership in a business, and businesses are productive and produce profits (or at least they should). Unlike an inert asset such as gold, where the investor only gains if the price increases, owning a business should be profitable even if the price of that business doesn't increase.

For example, if you buy the S&P 500 today, all those businesses should earn about 4.7% in the next year as a percentage of what you pay for them today[6]. As a business owner, the stock market investor benefits from those earnings, whether they are paid out directly as dividends or are used by management to reinvest in the business[7].

However, the primary reason the stock market rises over time isn't just that investors receive the current earnings of the underlying businesses, it's that those underlying earnings grow over time. Below is a near 100-year history of the S&P 500's earnings per share[8].

The record reflects that these earnings have grown over time and fortunately there are clear reasons for corporate profit growth to continue into the future: 1) the population grows and 2) technology advances and more efficiently produces better and more numerous goods and services.

It used to be that a country's stock market was tied to its domestic economy, but for the U.S. stock market that is increasingly less true. Forty percent of S&P 500 revenue now comes from abroad, so to a great extent our stock market represents the global economy.

---

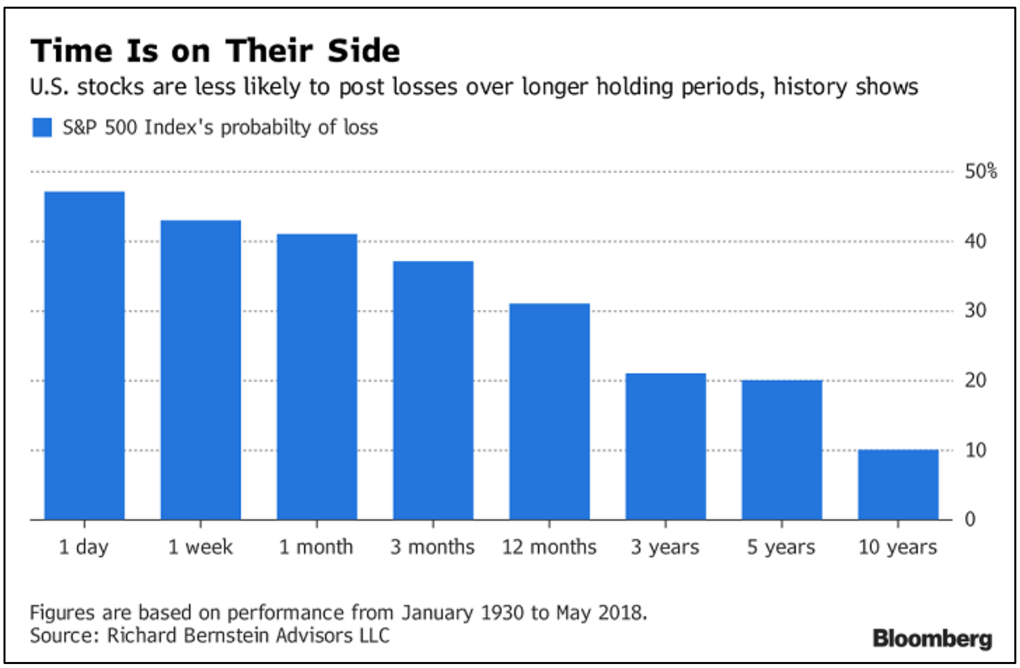
[6] An earnings yield is simply the inversion of a P/E; today's S&P 500 forward P/E is 21.6

[7] A third option often employed these days is to buy back and then retire shares of the company. The remaining investors benefit because fewer shares of the company outstanding increases their ownership percentage of the company.

[8] Note that it is the log of the earnings so it appears as a straight line.

If the world's population growth or economy were to slow or become less productive, our stock market growth would suffer. If the rule of law becomes disrupted or we are cut off from other markets, that growth could be negative. These things could happen. But if they don't, the most important reasons for the stock market continuing to advance remain intact. Growing corporate profits are not a fundamental law of nature. Yet, absent some catastrophic event, like a world war or communist revolution, they seem a pretty good bet based on a long history of experience. Hitching a ride on this growth is more important than the timing of exactly when you jump on or what exactly you pay to join the ride.

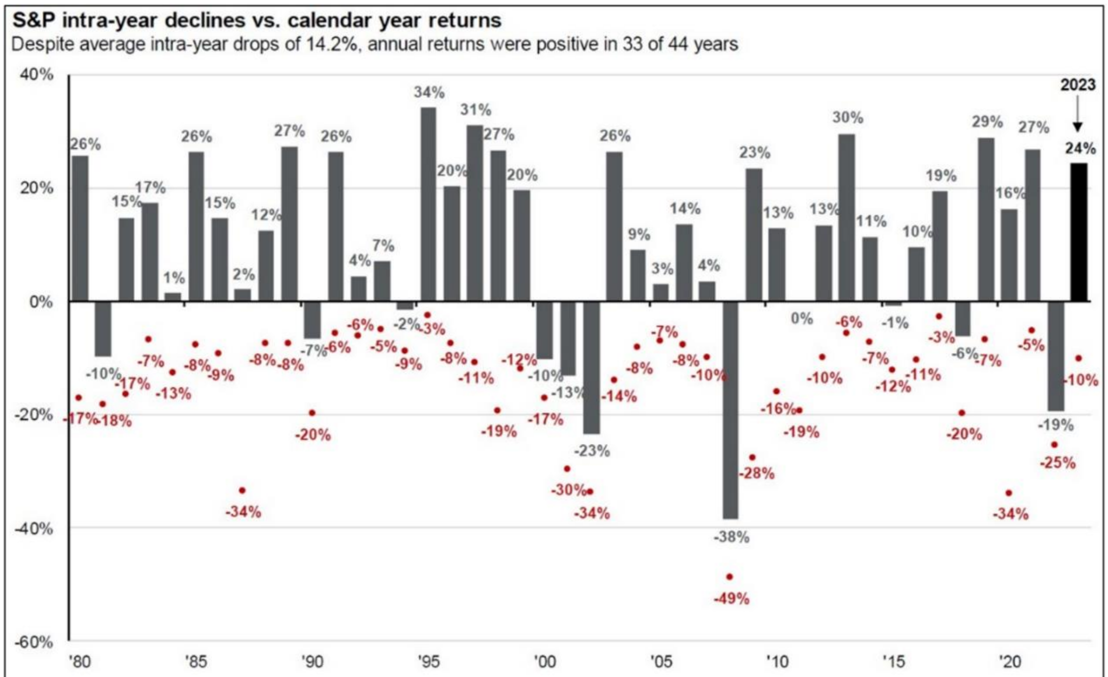
We have established that growing corporate profits drive the long-term growth of the stock market, but let's return to the idea that in the short term the market can go both up and down. The combination of these two factors means that the longer you invest in stocks, the more likely you are to have a positive experience, as indicated in the excellent graph below.



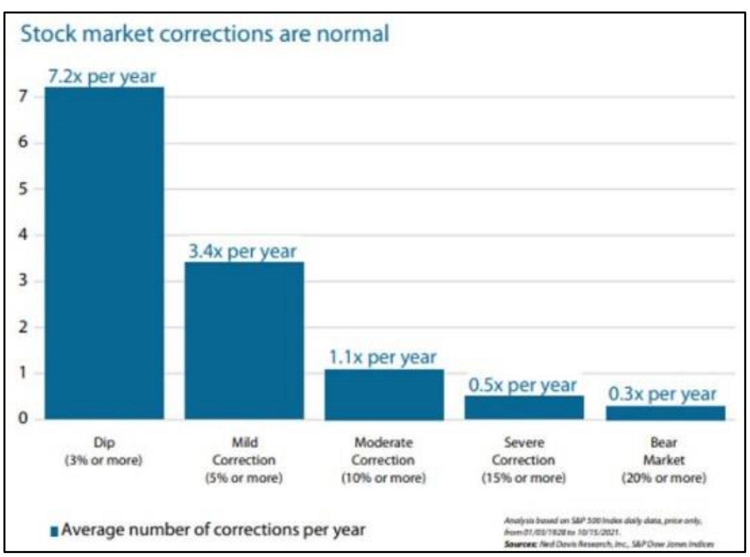
Here is another key idea you should take from this letter: ***history indicates that if you invest in the stock market for at least five years, you have an 80% chance of ending up with more money than when you started[9].*** Five years is a long time, but even over that extended period, profits are only likely and not guaranteed! This is a risk stock market investors must accept. We could very well be at the start of one of those periods right now. They do happen.

[9] The above chart references the period from 1930 to 2018 but we used Professor Shiller's data to check the entire 1871 to 2023 period: including dividends, a stock market investor would have made money in 90% of the possible 5-year periods (81% of the possible 5-year periods if adjusting for inflation).

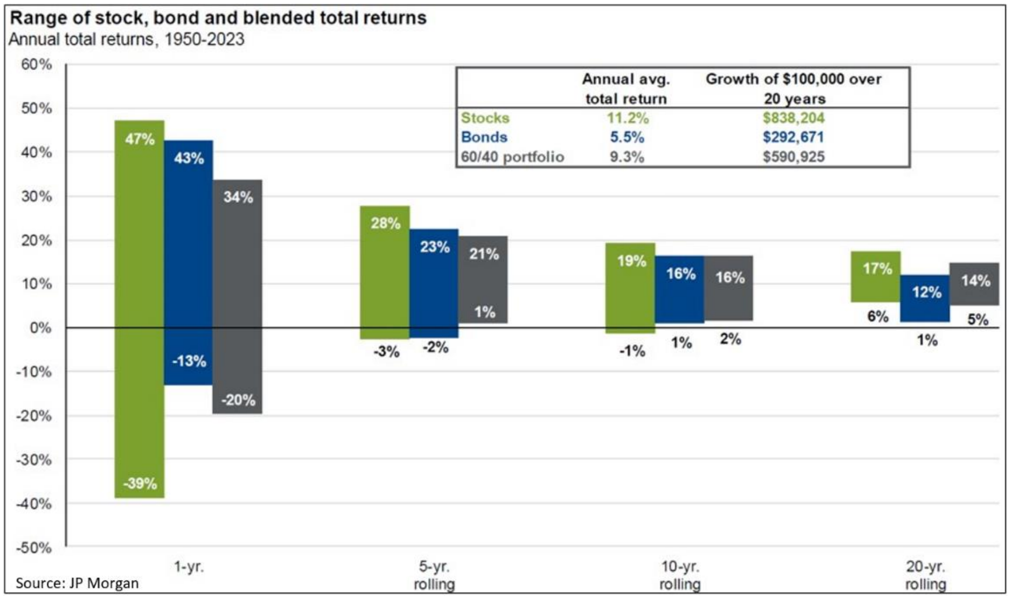
The below chart does a nice job of framing what you should expect from your stock market experience. Your portfolio is likely to decline in value at some point *every single year*, typically in the 5% to 15% range (The red dots represent the largest peak-to-trough decline during each calendar year). Nevertheless, despite those intra-year declines, most years finish with a positive return. Also note how the positive returns come in fits and starts. Over the last 30 years stocks delivered about a 10% return but that was hardly the experience in any typical year. The rewards of the stock market only come with acceptance that they might not come for years, and only after a bumpy ride.



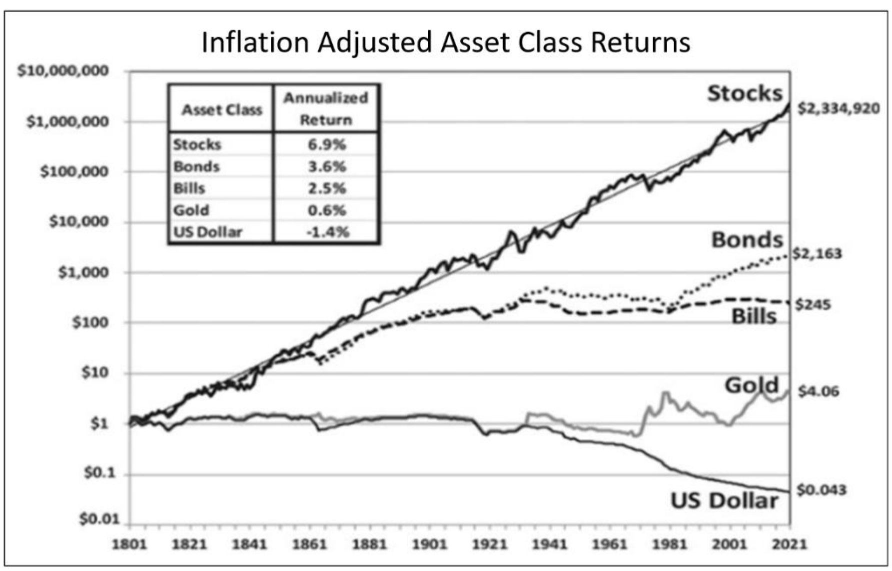
Source: JP Morgan



Stocks have been more rewarding than bonds over the long term – a trend we expect will continue. This is because bonds offer income but lack growth. So why bother with bonds? Because some investors have spending needs and do not have the luxury of the long-term horizon the stock market requires. Others cannot stomach the likelihood they will lose 5% to 15% of their account value at some point during most years or the notion that they will have to grind through a 50% decline (or two) during their investment life.



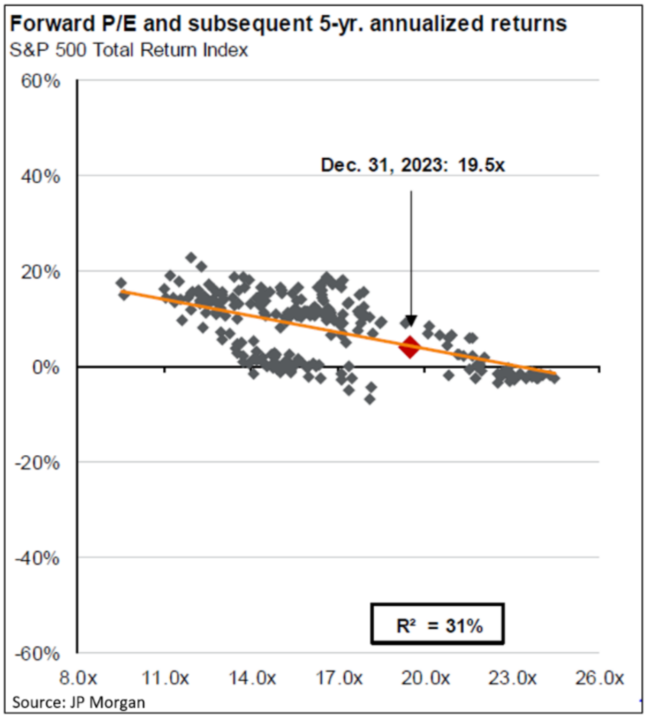
The above chart demonstrates that you can still achieve very satisfactory results with only 60% invested in stocks, and with less damaging downside scenarios. Thus, it is far better to be 60% invested in stocks *if you can stick with it,* versus piling 100% into stocks and catastrophically selling at the bottom when it gets scary[10]. For those unable to tolerate periods of meaningful (but temporary) portfolio declines, for reasons financial or psychological, solutions like our Managed Income strategy are more appropriate, and indeed far superior, to the usual loss-averting strategy: holding cash.



[10] Another way to think about your asset allocation is that it might be better to be 60% invested in stocks if it enables you to be reasonably happy with the slower and steadier progress vs. being 100% invested in stocks and losing sleep over it all the time, even if you aren't a panic-seller. Your temperament matters and there is no sense in being rich and miserable or worried about the stock market all the time.

Now we come to one of the most common questions we receive, "Is this a good time to invest in the stock market?". We will answer that question in two different ways.

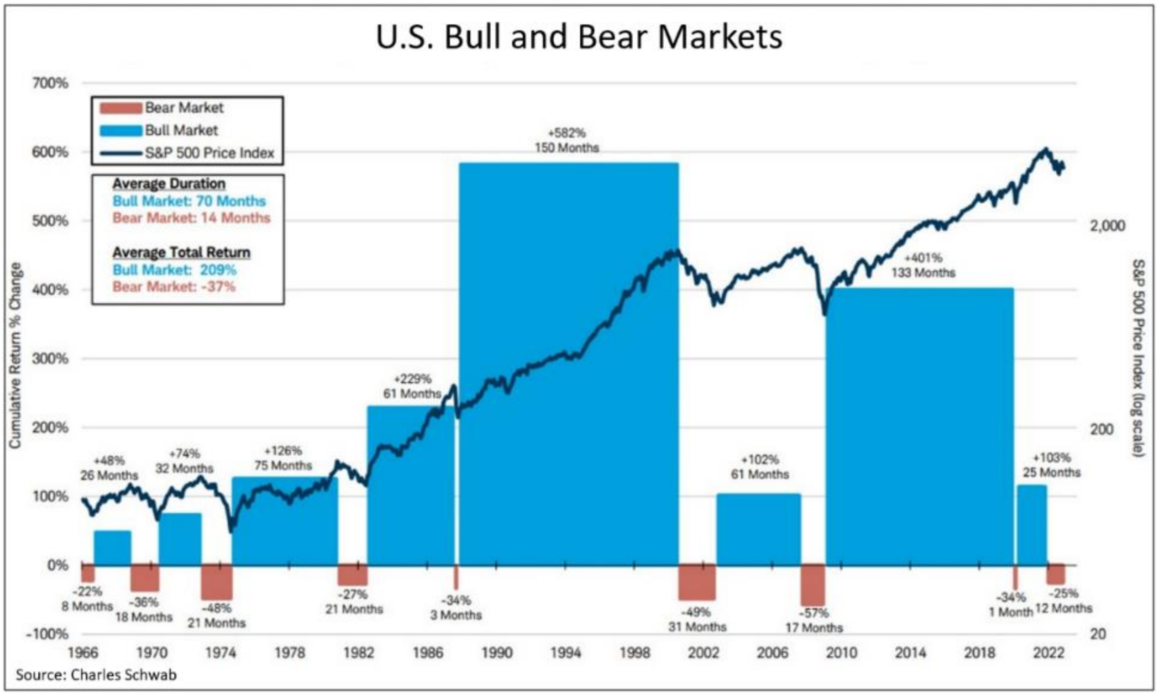
Answer #1: *Probably not!* The stock market returned 26% last year. The idea is to buy low and sell high, not the reverse. Today's market is on the expensive side. The below chart shows that regardless of current market valuation, both gains and losses are always possible. Still, you don't really see exceptional (10%+ annualized) 5-year forward performance results without lower starting valuations than we have today.



Answer #2: *We don't know and it doesn't matter!* This is truly the better answer. Timing the market is incredibly difficult. Serious and intelligent people believe it is impossible (don't incredibly difficult achievements often seem impossible?)[11]. We advise to forget about the timing because the true driver of wealth is achieving the long-term investment returns we have outlined. If you're constantly worried about getting into the market at a good time, you might end up not getting in at all. That is the *true* investment risk... missing out entirely for lack of certainty. Investment reality is that there are always things to worry about and you shouldn't let that hold you back.

We often see investor worry and paralysis. Someone is worried about something and avoids the stock market. They are sometimes initially right, and the stock market declines (we saw this during Covid). However, for "holding off" on investing to be a successful decision, one must also decide *when* to stop holding off and get invested. This second decision is often the more difficult one. The Covid bear market, amidst a total economic shutdown, lasted all of six weeks and by the end of 2020 the S&P 500 Index had returned 18% for the year. Many of those who sold and avoided the Covid crash also missed out on the subsequent 100% rally that quickly followed.

[11] We occasionally endeavor to protect clients by being contrarian but know for the odds to be in our favor we must be extremely selective in our timing. We usually do not know which way the stock market is about to head.



Our investment portfolios grew nicely in 2023. The year 2024 is unlikely to be as rewarding. That is ok and even to be expected. Keeping the long-term in mind, we are resolved to work through the inevitable periods of market difficulty as we head toward probable, but not guaranteed, long-term prosperity for the stock market and our clients.

Sincerely,

John Prichard

John G. Prichard

Miles E. Yourman

Miles E. Yourman

Kurt Beimfohr

Jeff Vieth

Past performance is not indicative of future results. The above information is based on internal research derived from various sources and does not purport to be a statement of all material facts relating to the information and markets mentioned. It should not be construed that the information in this commentary is a recommendation to purchase or sell any securities. Opinions expressed herein are subject to change without notice.