



EquityCompass

**Q1** 2022

Commentary,  
Review, & Outlook

# Bird In Hand *Versus* Two In The Bush



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## Bird In Hand Versus Two In The Bush

### 2022 First Quarter Commentary, Review, and Outlook

*The Hawk flew down to the tree and caught the Nightingale tightly in his claws and flew to a rock.*

*The Nightingale said, "Oh Mighty Hawk, please do not kill me. I am such a tiny bird. I will not be able to satisfy your hunger."*

*The Hawk smiled wickedly and said, "It is better to have something in my stomach than not have anything at all. Besides, a little bird I have is more important to me than a bigger one I have not caught."*

**Moral:** A bird in the hand is worth more than two in the bush.

— *The Hawk and the Nightingale, Aesop's Fables*

### Commentary

Perhaps one of the first investment primers was written 2,600 years ago by Aesop, the Greek storyteller credited with a number of moral lessons known as Aesop's Fables. "The Hawk and the Nightingale" is one of the most popular. The moral of the story and a commonly used proverb, "a bird in the hand is worth more than two in the bush," has become a simple thinking model used by investors for thousands of years.

Mathematics aside, when seeking to determine investment worth, "a bird in hand" decision is often influenced by risk attitudes. Optimistic investors may seek the opportunity to grab a couple of birds in the bush; pessimistic investors, unsure about the future, may prefer the certainty of owning just one bird.

In the first quarter of 2022, investors exemplified Aesop's hawk, as the price of long duration assets ("two in the bush") fell dramatically. Growth stocks, the value of which tend to depend on future earnings, experienced their worst quarterly performance. Investor preference was seemingly to own short duration assets ("bird in hand") including current earnings and dividends, commodities, and gold.

This choice is understandable. Recent events, including a new, aggressive Federal Reserve (Fed) policy to quickly raise interest rates against the backdrop of the highest inflation readings in 40 years have rattled stock and bond markets. Similarly, the Russian invasion in Ukraine has further amplified investors' fear. In March, the CNN Business Fear & Greed Index posted its

lowest rating and most bearish signal in years. The only lower reading occurred in the spring of 2020 at the height of the global pandemic.<sup>1</sup> With concern so high, it is not surprising that many investors have preferred the "bird in hand" investment.

However, it is important to understand "a bird in hand" may not be "worth more than two in the bush" without first considering the following three questions.

- 1) How certain are two birds in the bush?
- 2) How long will it take to get the birds?
- 3) What is the risk-free interest rate?

Warren Buffett worked out the math. He explained, if there are two birds in the bush and it takes five years to retrieve the birds, with a risk-free interest rate of 5%, then it is best to go with the bush as it provides a 14% compounded annual return.<sup>2</sup>

Applied to today's prospects, the futures market estimates the yield of the 10-year U.S. Treasury Note over the next two years is likely to be somewhere between 2.5%–3.0%—substantially below Buffett's 5% risk-free interest rate hurdle. Secondly, we believe there is a high probability that a broad group of high-quality, secular growth companies will continue to generate above-average economic returns in the years ahead. Lastly, in our opinion, it is extremely likely growth stocks will again achieve above-average price returns in the next five years—possibly sooner.

(1) CNN Business Fear & Greed Index, 03/07/2022.

(2) Berkshire Hathaway 2000 Annual Meeting.

Sometimes the mathematical attractiveness whether to opt for “two [birds] in the bush” is just too difficult to estimate. *How soon will two birds appear? How many birds will actually be in the bush? What will be the future interest rate?* At other times, even a conservative estimate to determine the future emergence of the two birds based on market prices may be stunningly too low. Today, in our opinion, the price of “two birds in the bush” is now attractive. While investors may prefer the psychological comfort of owning “a bird in hand,” perhaps the better return may be to now grab a few “in the bush.”

## Review

Major stock indices finished the first quarter of 2022 with the worst performance in two years. On the last day of the quarter, the S&P 500 Index declined for a 35th day—the greatest number of down days in a quarter dating back to 1984. For the first quarter, the Dow Jones Industrial Average declined by 4.10%, followed by the S&P 500 down 4.60%, while the technology-driven growth stocks within the NASDAQ Composite dropped 8.95%—by far the worst performing index.

Small and mid-cap stocks also posted negative returns in the first quarter. The S&P MidCap 400 Index declined 4.88%, outdone by the S&P SmallCap 600, which dropped 5.62%.

In the ongoing tug-of-war between growth and value stocks, the clear winner in the first quarter was value. The Russell 1000 Value Index declined a modest 0.74%—outperforming all of the broader indices. The Russell 1000 Growth Index fared much worse, down 9.04%. During the first quarter, by March 7, value stocks had outperformed growth by a wide margin of 14.2%—a 2.8 standard deviation above the historical average of the returns of value over growth. Since the first quarter of 1991, on a trailing three-month basis, value stocks have only exceeded the price return of growth stocks by this magnitude 1.5% of the time.

During the first quarter, the best performers were dividend-paying stocks—as demonstrated by the impressive 5.34% positive return of the S&P 500 Low Volatility High Dividend Index and the only broad equity index to generate a positive return for the quarter. In 2021, we highlighted the outperformance of dividend stocks in providing not only above-average income but also growth of income. Increasingly, investors have been turning to dividend stocks as the new bond

surrogates to seek higher income returns than what is currently available in the bond market, with the additional benefit of capital appreciation.

Parsing the internals of the S&P 500 Index in the first quarter, the best performing sector by a wide margin, was Energy, up 38.61% followed by the positive return of Utilities, which gained 4.53%. All other sectors of the market reported negative returns during the quarter: Consumer Staples -1.20%, Financials -1.61%, Industrials -2.48%, Materials -2.51%, Health Care -2.70%, and Real Estate -6.42%. By far the worst market performers were growth stocks among the following sectors: Information Technology -8.42%, Consumer Discretionary -9.08%, and Communication Services -11.98%.

Overseas, in the first quarter the MSCI ACWI ex-USA Index declined 4.81%. The best performing large developed foreign markets, in order were: FTSE 100 Index (United Kingdom) +1.78%, IBEX 35 Index (Spain) -3.08%, Nikkei 225 Index (Japan) -3.37%, Hang Seng Index (Hong Kong) -5.99%, CAC 40 Index (France) -6.89%, Kospi Index (South Korea) -7.39%, DAX Index (Germany) -9.25%, and the Shanghai A Share Index (China) -10.64%.

Equity markets endured a difficult first quarter, but the bond market faced even more challenges, posting its worst quarterly performance return since 1980. The Bloomberg U.S. Aggregate Bond Index declined 5.93%—a lower return than either the S&P 500 Index or the Dow Jones Industrial Average. Municipal bonds also declined—the Bloomberg U.S. Municipal Bond Index dropped 6.23%. For fixed income investors, it was a brutal three months. While bonds typically move in the opposite direction from equities, this quarter both were propelled on similar paths—downward.

An abrupt shift in the Fed’s approach to withdrawing monetary policy accommodation was the primary catalyst for the bond market’s exceptionally weak performance during the first quarter. To combat persistently high inflation that has so far defied policymakers’ “transitory” expectations, the Fed raised interest rates by 25 basis points in March and signaled an aggressive series of additional rate hikes to come over the next 12–24 months. In response to a more hawkish Fed, the 10-year U.S. Treasury yield rose by 83 basis points for the quarter to 2.34%—its highest monthly close since April 2019.

## Outlook

Investing requires decision-making with uncertainty. There is no crystal ball that can predict market prices in the future. However, it has been well documented that over a longer time horizon, stock prices are more likely to be higher than lower. This, we believe, is a testament to the spirit of democratic capitalism which has been the backbone of our economic system for over 200 years.

Even so, major political, economic, and military events are often unsettling, particularly those involving armed conflict—such as the Russian invasion of Ukraine. Estimating the probabilities of geopolitical outcomes, military combat included, is difficult at best. Having said this, we can examine past major events to determine some sense of the market's historical behavior in light of their uncertainty. Excluding the Russian invasion of Ukraine, over the last 82 years, there have been 37 dramatic market headlines beginning with the German invasion of France in the spring of 1940 to the most recent—the U.S. departure from Afghanistan in 2021. Study reveals following a brief selloff from the onset of each event, the average S&P 500 Index return was 7.1%; 12 months later, the average return was 10.8%. On the other hand, events concurrent with an economic recession fared less well—after six months the average S&P 500 Index total return was -6.1%; after 12 months, -11.5%.<sup>3</sup>

In the end, earnings matter most for stock prices. Our research shows that when 12-month forward earnings estimates are rising, stock prices typically follow. Conversely, a decline in 12-month forward earnings estimates often signal a forthcoming recession, which typically results in a bear market. It is worth noting, despite the Fed's stated intention to raise interest rates and the continued military conflict in Ukraine, the forecast for S&P 500 12-month forward earnings estimates remains positive—a good sign for stock prices.

In our [Market Outlook 2022](#), we suggested perhaps the biggest risk to the economy, and subsequently the stock market, might be the ability of the Federal Reserve to terminate its quantitative easing program of buying bonds in the open market while raising interest rates in an environment in which economic growth was beginning to decelerate. For over 45 years, the Federal Reserve has raised interest rates into an

economy that is growing—*not slowing*. This year will be different. As we stated, threading this economic needle will be tricky in 2022.

Thus far, the economic news remains positive. As of April 1, the majority of our high-frequency indicators are in favorable territory indicating economic growth remains in an upward trajectory. As Jim DeMasi, EquityCompass Senior Portfolio Manager and head of fixed income strategy, points out, the aggregate benefit from workers returning to their offices has more than offset the economic costs associated with higher inflation and higher interest rates.

The strong labor market, explains Jim, continues to serve as the primary growth driver for the economy. Despite the intense market volatility and negative geopolitical headlines, the U.S. economy continues to recover jobs lost during the pandemic at a record clip. Of note, non-farm payrolls increased by 431,000 jobs in March. The unemployment rate dropped by 0.2% to 3.6%, putting this key measure of labor force utilization just 0.1% above its pre-pandemic trough of 3.5%.

However, despite the continued good news, it is important to observe that although U.S. economic growth remains positive, the rate is slowing back to the long-term sustainable U.S. real gross domestic product (GDP) growth rate—we have reached the peak of economic growth made possible by abnormally low interest rates and massive fiscal spending as a result of the global pandemic. From here, interest rates will be higher and government spending will decrease from 2020–2021. It is important to understand the stock market typically struggles with decelerating growth, and slowing economic growth often brings about a regime change in market leadership.

Value stocks tend to perform well from the bottom of an economic recession to the peak of the economic expansion. The business models of value stocks are generally better geared to an expanding economy, which translates into higher earnings growth rates and higher returns on invested capital. Value stocks typically post a much higher rate of change in earnings growth rates and returns on capital compared to growth stocks during an economic expansion—as we have seen with the outperformance of value over growth the last 18 months.

Once economic growth peaks and begins to decline, earnings growth and return on invested

(3) LPL Research, Standard & Poor's, Dow Jones Indices, CFRA, Strategas, 2/22/2022.

capital among value stocks tend to decline much more relative to the change in earnings and return on capital for growth stocks, which are generally more stable over an economic cycle. Growth stocks typically outperform value at the peak of the economic expansion through the bottom of the next recession.

In addition, the dramatic first quarter selloff among growth stocks due to an increase in the yield of the 10-year U.S. Treasury Note from 1.5% at year end to the current 2.4% level has now made growth stocks more attractive. During the first quarter, the NASDAQ Composite fell into a bear market, down 21% with two-thirds of the stocks in the index down 25%; 40% of constituents down 50%; and one-quarter down 75%. Growth stocks are now much cheaper in this point of the economic cycle when their business models typically begin to perform well relative to value.

This is not to say we believe ALL value stocks are destined for relative underperformance. Within the value camp, we believe higher dividend-paying value stocks with yields of 3%–5% will remain particularly attractive in 2022, not because they will economically outperform growth stocks but because of their ability to generate greater income returns than currently available in the bond market.

With the bond market set to post negative returns for the second year in a row, some investors may have chosen to shift a portion of their fixed income portfolio to higher dividend-paying stocks. Not only are the yields of many equity

income stocks higher than bonds, but the dividend growth, along with underlying capital appreciation, offer enhanced real income returns for investors in a high inflationary environment.

It is for these reasons we strongly recommend investors reallocate their equity portfolio *equally* among high dividend-paying value stocks and secularly advantaged growth stocks. We believe this barbell approach to portfolio management seeks to provide balance and alleviate the guesswork among the ongoing value and growth style rotation. Perhaps just as important, this barbell strategy seeks to avoid the underperforming muddled-middle—value stocks with low or no dividend yield and yesterday's growth stocks that are no longer secularly advantaged to provide above-average earnings growth and high returns on invested capital.

All the same, we counsel investors to brace for continued high stock market volatility. Decelerating economic growth, higher interest rates, and stubbornly high inflation that will take time to recede, coupled with continued geopolitical tensions in Eastern Europe will continue to make for a dramatic headline-driven market—further fuel for potentially big swings in stock prices.

Even so, we remain confident U.S. GDP growth will be positive in 2022. Corporate earnings should grow year over year and, although interest rates may be marginally higher by year end, we are not of the opinion slightly higher interest rates will be enough to unseat the overall direction of the stock market.

## About the Author



**Robert G. Hagstrom, CFA**, is Chief Investment Officer of EquityCompass Investment Management, LLC and Senior Portfolio Manager of the Global Leaders Portfolio. He joined EquityCompass in April 2014 and launched the Global Leaders Portfolio in July 2014. Robert was appointed Chief Investment Officer in March 2019.

Robert has more than 30 years of investment experience. Prior to joining EquityCompass, he was Chief Investment Strategist at Legg Mason Investment Counsel, and before that, the Portfolio Manager of the Growth Equity Strategy at Legg Mason Capital Management for 14 years where he managed \$7 billion in assets. Robert received “Honorable Mention” recognition in Morningstar’s Domestic-Stock Fund Manager of the Year in 2007 while with Legg Mason.<sup>§</sup>

Robert is the author of ten investment books including The New York Times Best Seller, *The Warren Buffett Way*, widely considered to be the definitive book on the investment approach and strategies of Warren Buffett. The book has sold over one million copies worldwide and is translated into 17 foreign languages. In addition, Robert wrote, *Investing: The Last Liberal Art*, a multidiscipline examination of investing and decision making. His latest book, published in 2021, is *Warren Buffett: Inside the Ultimate Money Mind*. Robert earned his Bachelor’s and Master’s of Arts degrees from Villanova University. He is a Chartered Financial Analyst, a member of the CFA Institute, and the CFA Society of Philadelphia. Robert is also a member of the Global Interdependence Center.

§ Established in 1988, the Morningstar Fund Manager of the Year award recognizes portfolio managers who demonstrate excellent investment skill and the courage to differ from the consensus to benefit investors. To qualify for the award, managers’ funds must have not only posted impressive returns for the year, but the managers also must have a record of delivering outstanding long-term performance and of aligning their interests with shareholders’. The Fund Manager of the Year award winners are chosen based on Morningstar’s proprietary research and in-depth evaluation by its fund analysts. For more information about Morningstar Awards, visit <https://go.morningstar.com/Morningstar-Awards>.

### About EquityCompass

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The EquityCompass team of professionals represents deep industry experience in security analysis, capital markets, and portfolio management. We are committed to a consistent investment process that relies on enduring principles, sound empirical reasoning, and the recognition of a dynamic investment environment with a global reach.

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The Dow Jones Industrial Average (DJIA) is an unmanaged, price-weighted index that consists of 30 blue chip U.S. stocks selected for their history of successful growth and interest among investors. The price-weighted arithmetic average is calculated with the divisor adjusted to reflect stock splits and occasional stock switches in the index. The S&P 500 Total Return Index tracks both the capital gains of the stocks in the S&P 500 Index over time, and assumes that any cash distributions, such as dividends, are reinvested back into the index. Looking at an index's total return displays a more accurate representation of the index's performance. By assuming dividends are reinvested, you effectively have accounted for stocks in an index that do not issue dividends and instead, reinvest their earnings within the underlying company. The S&P 500 Low Volatility High Dividend index measures the performance of the 50 least-volatile high dividend-yielding stocks in the S&P 500. The index is designed to serve as a benchmark for income-seeking investors in the U.S. equity market. The NASDAQ Composite Index, comprised mostly of technology and growth companies, is a market value-weighted index of all common stocks listed on NASDAQ. The S&P MidCap 400<sup>®</sup> provides investors with a benchmark for mid-sized companies. The index covers over 7% of the U.S. equity market, and seeks to remain an accurate measure of mid-sized companies, reflecting the risk and return characteristics of the broader mid-cap universe on an on-going basis. The S&P SmallCap 600<sup>®</sup> seeks to measure the small-cap segment of the U.S. equity market. The index is designed to track companies that meet specific inclusion criteria to ensure that they are liquid and financially viable. The Russell 1000 Growth Index measures the performance of those Russell 1000 index companies with higher price-to-book ratios and higher forecasted growth values. The Russell 1000 Value Index measures the performance of those Russell 1000 index companies with lower price-to-book ratios and lower forecasted growth values. The MSCI ACWI ex USA Index captures large and mid cap representation across 22 of 23 Developed Markets (DM) countries (excluding the U.S.) and 25 Emerging Markets (EM) countries. With 2,330 constituents, the index covers approximately 85% of the global equity opportunity set outside the U.S. The Korean Composite Stock Price Index (KOSPI) is a market capitalization weighted index comprised of 200 of the largest and most liquid issues traded on the Korean Stock Exchange. The IBEX 35 is the official index of the Spanish Continuous Exchange. The index is comprised of the 35 most liquid stocks traded on the Continuous market. It is calculated, supervised and published by the Sociedad de Bolsas. The equities use free float shares in the index calculation. The Nikkei 225 Stock Average is a price-weighted index composed of Japan's top 225 blue-chip companies traded on the Tokyo Stock Exchange. The Hang Seng Index is a market capitalization-weighted index of the largest companies that trade on the Hong Kong Exchange. The index aims to capture the leadership of the Hong Kong exchange and covers approximately 65% of its total market capitalization. The CAC 40 Index is a market-capitalization weighted index of the 40 largest and most liquid companies traded on the Paris Bourse stock exchange. The FTSE 100 is a market-capitalization weighted index of UK-listed blue chip companies designed to measure the performance of the 100 largest companies traded on the London Stock Exchange that pass screening for size and liquidity. The Shanghai A-Share Stock Price Index is a capitalization-weighted index tracking the daily price performance of all A-shares listed on the Shanghai Stock Exchange that are restricted to local investors and qualified institutional foreign investors. The DAX (Deutscher Aktienindex) Index is a blue chip index in Germany tracking the performance (including dividends) of the 30 most actively traded stocks on the Frankfurt Stock Exchange. The Bloomberg U.S. Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate pass-throughs), ABS and CMBS (agency and non-agency). Indices are unmanaged, do not include fees and expenses, and it is not possible to invest directly in an index. The Bloomberg Municipal Bond Index measures the performance of the U.S. municipal bond market. It is composed of approximately 1,100 bonds; 60% of which are revenue bonds and 40% of which are state government obligations. CNN Business Fear & Greed index calculates which emotion - fear or greed - may be driving investor decisions based on seven indicators: Stock Price Momentum, Stock Price Strength, Stock Price Breadth, Put and Call Options, Junk Bond Demand, Market Volatility, and Safe Haven Demand. Each indicator is examined on a scale from 0 - 100 to determine how far it has veered from the average relative to how far it normally veers. The higher the reading, the greedier investors are being; 50 is neutral. All scores are aggregated and equally weighted to arrive at a final index reading.

All index returns are shown on a total return basis and assume that all cash distributions, such as dividends, are reinvested. The volatility of the indices identified in this report may be materially different from the volatility of the model portfolios presented by EquityCompass. Indices are unmanaged, do not reflect fees and expenses, and are not available for direct investment.

\*Total assets combines both Assets Under Management and Assets Under Advisement as of March 31, 2022. Assets Under Management represents the aggregate fair value of all discretionary and non-discretionary assets, including fee paying and non-fee paying portfolios. Assets Under Advisement represent advisory-only assets where the firm provides a model portfolio and does not have trading authority over the assets.

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