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Performance Reports

Q4 2020 Newsletter | Jeff Griggs, CFA

Due to the wide range of risk tolerances of our clients, some topics or asset classes may have more, less, or no importance to your portfolio. For a detailed analysis, give us a call, or request a detailed performance review.

Big Picture

2020 has treated us to the fastest bear market, fastest recession, and fastest bull market in history. With a contentious presidential election underway and vaccine news breaking daily, the wild ride is likely to continue into the fourth quarter. Biden is currently favored to win the election and while that likely means higher tax rates for corporations, the pain may be offset by more generous COVID-19 stimulus, making the presidential election a bit of a wash as far as the stock market is concerned. The S&P 500 has now risen 51.75% since it's March 23rd low causing many investors to fear overvaluation. The forward P/E on the S&P 500 ended the quarter at 21.74, high historically, but if catastrophe can be averted, it is easily justified given extremely low interest rates and the dominance of high-margin tech companies within the index. Howard Marks explains the concept well in his most recent memo, to summarize, the Capital Market Line is an economic concept that argues all investments from the 30-day T-bill (the risk-free rate) to Emerging Market stocks should offer the same ratio of risk-to-reward. When Treasury's yield a more normal 3%, investors might require a 6.5% return from stocks, a 3.5% premium to justify the greater risk. Earnings yield is simply the inverse of the price-to-earnings, or P/E, ratio so a 6.5% earnings yield equates to a 15.4x P/E ratio, roughly the average we have seen since WWII. However, when Treasury's only offer a 1% yield, like they do now, the required earnings yield on stocks drops to just 4.5% which equates to a P/E ratio of 22.2x. In a very basic, theoretical sense, this is why low interest rates push stock prices up and justify higher valuations.

Looking Ahead

From a mortgage crisis caused by mass evictions and foreclosures, to a sovereign-debt crisis in emerging markets, it is easy to brainstorm a number of ways that the coronavirus pandemic causes a catastrophic financial crisis that ripples across global capital markets and ushers in a severe recession/depression. However, I believe the highest likelihood is that central banks and national governments provide enough relief, assistance, and stimulus to prevent a major crisis until a viable vaccine is widespread and the planet can finally get back to "normal."

So, if we allow ourselves to accept the hypothesis that a massive crisis is avoided through massive stimulus, we are left in a low rate, low long-term growth environment that is not dissimilar from the environment we have been operating in for the last decade or so. Investors are basically left with three choices, maintain traditional asset allocations and accept very low expected returns from portfolios, increase risk to search for the expected returns we are used to, or go to cash and await a better opportunity. The bull market that followed the global financial crisis, and the bull market that began after the lightning fast bear market and recession we experienced earlier this year, suggest most investors are opting for option 2. This means increasing equities (and growth-oriented equities at that), decreasing credit-quality, and minimizing duration-risk. I will admit it is not a position that feels good. Normally, in situations where the stock market faces an obstacle as ominous as the coronavirus pandemic, we find many investors that are unwilling or unable to take risk at any price. This provides investors, with the fortitude to act, incredible buying opportunities. We saw this at the bottom of the GFC recession, but today, given the Fed's new playbook, investors are flush with capital and there is a perceived "Powell Put" that gives investors confidence they would not otherwise have. So, while I believe the best future course is to remain invested, and even at above-average risk, we are not seeing the opportunities that are usually present during crises like this.

On the Fridge

Emerging Markets

As the rally continued in the third quarter, Emerging Market stocks rose 9.7%, beating their US counterparts by just 0.1% and handily outperforming Developed Markets which rose just 5% in the quarter.

Consumer Discretionary

The Consumer Discretionary sector beat all others for the second quarter in a row, rising 15.1%, as consumers continue to find ways to spend despite the restrictions the COVID-19 pandemic present.

In the Dog House

Energy

The energy sector fell –19.7% in the quarter and was the only sector to finish the quarter in the red in what was otherwise a great quarter for stocks. Oil prices only fell about a $1/barrel in the quarter, but the COVID-19 pandemic continues to suppress demand.

Government Bonds

Government bonds returned just 0.2% in the quarter as rates dropped initially but recovered to end the quarter essentially flat.

Links and Articles

Coming into Focus
Howard Marks of Oaktree Capital offers his insights on the market

Estimated Rental Shortfall Infographic
Advisory firm, Stout, provides an interesting infographic mapping potential housing crisis

GDP slides 31.4% in second quarter
The AP highlights the continued economic devastation despite equity gains

House Delays Vote on Stimulus
CNBC highlights lawmakers playing election politics with the economic recovery

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Performance

Stocks continued their impressive recovery rising 8.3% in the quarter, led by emerging markets (+9.7%) and US stocks (+9.6%), while developed markets trailed rising only 5%. Perhaps unsurprisingly given their higher correlation to equities, high-yield bonds outperformed all other subclasses of fixed income rising 4.6% in the quarter vs. just 1.5% for their investment-grade counterparts. Government bonds returned only 0.2% as treasury rates dipped and recovered in the quarter to end basically flat. Fixed income securities are offering very little yield (2.02% yield on corporate bonds) and unlike equities, they offer little upside potential if we manage to ride out this pandemic relatively unscathed. For that reason, I find bonds fairly unattractive. However, the duration of long dated treasuries offer an attractive "put option" (should do well if stocks fall) for portfolios, as it seems very unlikely that we see a significant rise in interest rates any time soon. In the meantime, high-yield bonds at least offer some yield relative to investment grade options (4.61% yield). Third quarter earnings are expected to fall –3%, better than the –5.5% decline that was expected at the start of the quarter. Fourth quarter earnings are expected to fall an additional –1.33% to bring 2020 calendar year earnings to just –2.73%, far better than many estimates when the nationwide lockdown began. Analysts predict we will return to growth in the first quarter of 2021, with Q1 earnings expected to rise 3.07%, on their way to 8% growth for the full year.

	2020 Q3	YTD	LTM	3yr	5yr	10yr
Cash	0.0%	0.5%	1.0%	0.1%	1.1%	0.6%
Fixed Income	2.7%	5.7%	6.2%	4.1%	3.9%	2.4%
Fixed Income Blend	2.7%	5.7%	6.2%	4.1%	3.9%	2.4%
Government	0.2%	8.8%	7.9%	5.5%	3.7%	3.1%
Inflation Protected	3.0%	9.2%	10.1%	5.8%	4.6%	3.6%
Municipal	1.2%	3.3%	4.1%	4.3%	3.8%	4.0%
Floating Rate	0.1%	0.6%	1.1%	1.7%	1.3%	0.0%
Corporate	1.5%	6.6%	7.9%	6.4%	6.0%	5.1%
High Yield	4.6%	0.6%	3.2%	4.2%	6.8%	6.5%
International Bond	4.1%	4.8%	5.5%	3.1%	3.6%	1.3%
Equity	8.3%	1.8%	11.0%	7.7%	10.9%	9.1%
Equity Blend	8.3%	1.8%	11.0%	7.7%	10.9%	9.1%
US Equity	9.6%	7.3%	17.0%	12.8%	14.4%	13.9%
Developed Markets	5.0%	-6.7%	0.6%	1.1%	5.9%	4.9%
Emerging/Frontier	9.7%	-0.9%	10.9%	2.8%	9.4%	2.9%
Alternatives	2.3%	-1.1%	0.4%	0.8%	1.4%	1.6%
Alternatives Blend	2.3%	-1.1%	0.4%	0.8%	1.4%	1.6%

	2020 Q3	6mo	YTD	1yr	3yr	5yr	10yr
Information Technology	12.0%	46.1%	28.7%	47.1%	28.1%	27.2%	20.5%
Financials	4.4%	17.2%	-20.2%	-11.8%	-0.1%	7.8%	9.7%
Health Care	5.9%	20.3%	5.0%	20.1%	11.1%	11.9%	15.4%
Consumer Discretionary	15.1%	52.9%	23.4%	28.8%	20.5%	17.0%	18.2%
Consumer Staples	10.4%	19.3%	4.1%	7.8%	9.0%	9.4%	11.8%
Industrials	12.5%	31.6%	-4.0%	1.3%	4.5%	10.8%	11.6%
Energy	-19.7%	4.8%	-48.1%	-45.2%	-20.4%	-9.7%	-3.2%
Utilities	6.1%	9.0%	-5.7%	-5.0%	7.5%	10.3%	10.7%
Materials	13.3%	42.8%	5.5%	12.2%	6.2%	12.2%	9.4%
Communication Services	8.9%	30.8%	8.6%	18.3%	9.3%	10.6%	9.4%
Real Estate	1.9%	15.4%	-6.8%	-7.3%	6.7%	7.9%	10.5%

Source: Morningstar; The 1,3,5, and 10 year performance is annualized.

The consumer discretionary sector led all others in the third quarter, rising 15.1%. While Materials and Industrials surprised by rising 13.3% and 12.5%, respectively, good for 2nd and 3rd place in the quarter. Energy ended the quarter as the only sector in the red, and it was red by a mile falling –19.7%. Energy earnings fell –32% in the third quarter, and are expected to fall –28% in the fourth, before returning to growth in 2021.

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Asset Class	Benchmark	Description
Cash	BBgBarc US Treasury Bill 1-3 Mon TR USD	Measures US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury.
Fixed Income	BBgBarc Global Aggregate TR Hdg USD	The Bloomberg Barclays Global Aggregate Index is a flagship measure of global investment grade debt from twenty-four local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging market issuers.
Government Bonds	BBgBarc US Government TR USD	The Bloomberg Barclays US Government Bond Index comprises the US Treasury and US Agency indices. The index includes US Dollar-denominated, fixed-rate, nominal US Treasuries and US agency debentures (securities issued by US government owned or government sponsored entities, and debt explicitly guaranteed by the US government).
Inflation Protected	BBgBarc US Treasury US TIPS TR USD	The Bloomberg Barclays US Treasury Inflation-Linked Bond Index (Series-L) measures the performance of the US Treasury Inflation Protected Securities (TIPS) market.
Municipal	BBgBarc Municipal TR USD	The Bloomberg Barclays U.S. Municipal Index covers the USD-denominated long-term tax exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds and prerefunded bonds.
Floating Rate	BBgBarc US Trsy Floating Rate TR USD	The Bloomberg Barclays US Treasury Floating Rate Index measures the performance of floating rate bonds issued by the US Treasury.
Corporate Bonds	BBgBarc US Corp IG TR USD	The Bloomberg Barclays US Corporate Bond index measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD-denominated securities publicly issued by US and non-US industrial, utility and financial issuers.
High Yield Bonds	BBgBarc US Corporate High Yield TR USD	The Bloomberg Barclays US Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below.
International Bonds	BBgBarc Gbl Agg Ex USD TR Hdg USD	The Bloomberg Barclays Global Aggregate Index is a flagship measure of global investment grade debt from twenty-four local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging market issuers. This version excludes USD-denominated debt.
Equity	MSCI ACWI GR USD	The MSCI ACWI captures large and mid cap representation across 23 Developed Markets and 23 Emerging Markets countries. With 2,477 constituents, the index covers approximately 85% of the global investable equity opportunity set.
US Equity	MSCI USA GR USD	Captures broad US equity coverage. The index includes 3,108 constituents across large, mid, small, and micro capitalizations, representing about 99% of the US equity universe.
Developed Market Equity	MSCI World ex USA GR USD	Captures large and mid cap representation across 22 of 23 Developed Market countries, excluding the United States. With 1,023 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.
Emerging Market Equity	MSCI EM GR USD	The MSCI Emerging Markets Index captures large and mid cap representation across 23 Emerging Markets (EM) countries. With 829 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.
Alternatives	Wilshire Liquid Alternatives TR USD	Measures the collective performance of the five Wilshire Liquid Alternative strategies that make up the Wilshire Liquid Alternative Universe, including the Wilshire Liquid Alternative Equity Hedge, Global Macro, Relative Value, Multi-Strategy, and Event Driven indices. This index is meant to provide a representative baseline for how the liquid alternative investment category performed as a whole. Constituents comprised of '40 Act mutual funds.
US Large Cap Equity	S&P 500	Widely regarded as the best gauge of large-cap US Equities. The S&P 500 is a market-weighted index that includes 500 leading companies and captures approximately 80% coverage of available market capitalization.