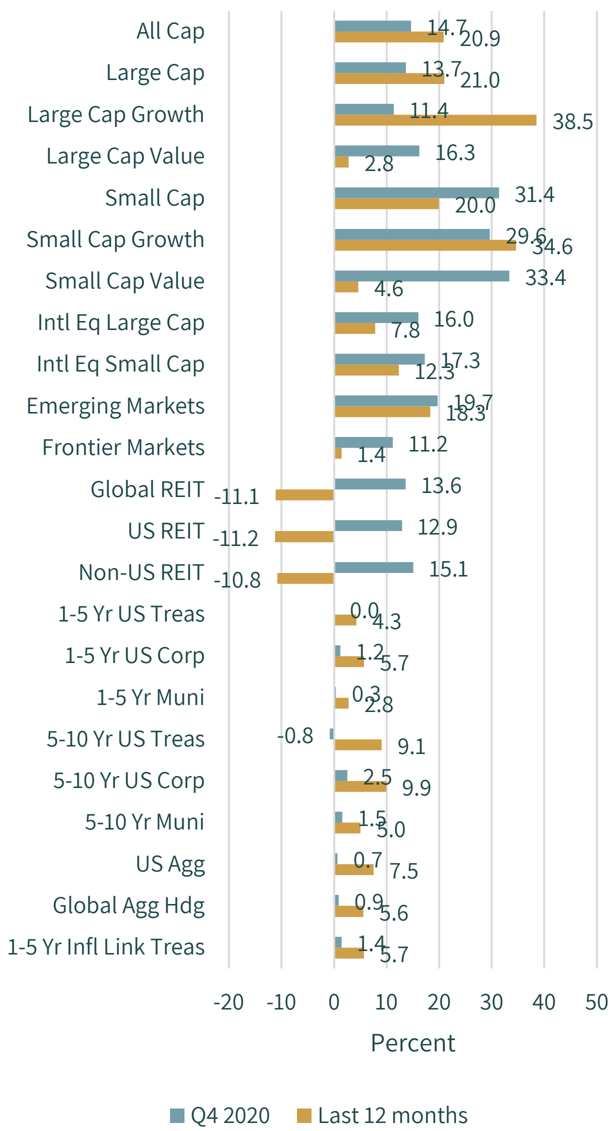
Quarterly Investment Commentary
Q4 2020

Overview

PERIODIC RETURNS



Source: Morningstar; Russell, MSCI, Dow Jones, Bloomberg Barclays, ICE BoA ML benchmarks shown; past performance is not indicative of future results

KEEPING A BALANCED APPROACH

Summary:

- Q4 delivered strong equity returns.
- Biden wins the Presidential election; Democrats control Congress too.
- 20/20 foresight would have been helpful for the rollercoaster ride that was 2020.

Positive Signals:

- ✓ Vaccines for Covid-19 are available.
- ✓ The Fed remains accommodative; has shown willingness to step in
- ✓ $900B aid/stimulus package passed in late December.
- ✓ EU and UK reach Brexit agreement.

Reasons for Concern:

- ✓ The coronavirus is still with us; vaccine rollout may be slow and is full of logistical complications.
- ✓ Economic activity remains below pre-Covid levels.
- ✓ A ‘K-shaped’ recovery creating divergences.

A Rollercoaster Ride

For anyone that has ridden a rollercoaster, you understand both the thrills and stomach-churning feelings that come with the experience. For investors, these were likely similar feelings you had throughout the year as well. Consider this: in 2020, we had the fastest bear market in history followed by the fastest recovery, all brought on by the Coronavirus, impacting global businesses, large and small.

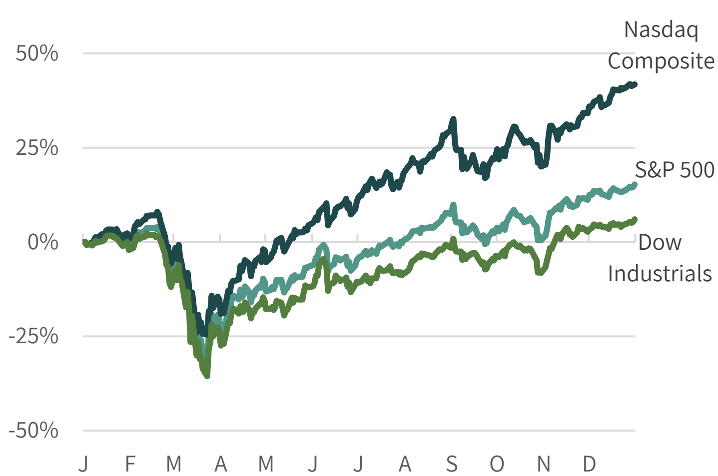
Through it all, there were some important lessons to take away from all of this:

Picking winners consistently is hard: Consider that the small cap-oriented Russell 2000 Growth led all equity benchmarks in December with a 9.3% return. However, it was the Russell 2000 Value benchmark which had the highest return for the 4th quarter (33.4%). And yet the Russell 1000 Growth posted the best return for the year at 38.5%.

It is really difficult to time the markets and move to cash: Throughout the years we have likely shown you charts indicating how different (i.e. lower) returns are for investors that miss the best market days because they don't stay invested. 2020 brought us another great example. If you think back to the end of March 2020 when the Russell 1000 was down over 20% YTD and the Russell 2000 had fallen by more than 30% YTD, would you have believed back then that their respective returns would end up being positive for the year? Investors that went to cash in March/April likely missed out on the extraordinary rebound.

The market is not the economy: Even with higher unemployment levels and economic challenges due to Covid-19, the major indexes (e.g. Dow, S&P 500, Nasdaq) each hit new highs in 2020 and finished well above where they started the year (see Exhibit 1 for more details). Remember, markets make estimates about what the future is expected to look like, not necessarily what the present is.

Figure 1: Index Performance in 2020



Source: St. Louis FRED

Do not believe the hype: Wall Street is full of people making forecasts. While the people making these prognostications are well-intentioned with very well-thought-out arguments supporting their views, the reality is it is incredibly difficult to get forecasts consistently correct regarding the economy and markets. Do you remember people predicting in December 2019 that the coronavirus was going to cause a global shutdown and that we would all be scouring store shelves for toilet paper?

In fact, in a review of predictions (see Exhibit 2) from various Wall Street strategists, while missing the coronavirus completely, many still anticipated returns to be much more muted than they actually were.

Figure 2: Review of Predictions

Firm(s)	2020 S&P 500 forecast	% difference from actual
BMO & Goldman Sachs	3,400	-10.5%
Citigroup & Bank of America	3,300	-13.8%
Stifel	3,100	-21.2%
Morgan Stanley & UBS	3,000	-25.2%
Source: WSJ, November 29, 2019; the S&P 500 finished 2020 at 3,756.07, Source: Yahoo! Finance		

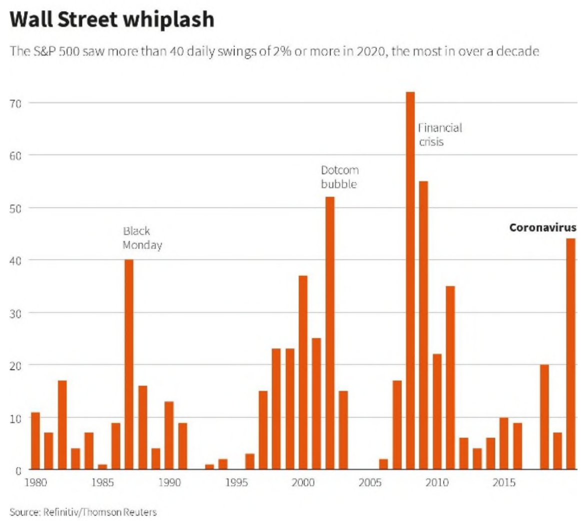
U.S. Equity

U.S. equities started off the quarter with mixed results in October as large caps were negative while small caps were positive. There was more volatility towards the end of the month as increased coronavirus cases brought the specter of more lockdowns, as well as some uncertainty brought on by the election. November was, quite literally, a month for the record books with U.S. equity benchmark returns between 10-20%, stemming from optimism about the U.S. being close to approving a vaccine. Indexes like the Russell 2000 and 2000 Value recorded their highest return in their history while the Russell 2000 Growth and Russell 1000 Value had their second highest monthly returns in their history (inception of December 31, 1978).

For the 4th quarter, small cap stocks were on a tear as the Russell 2000 rocketed upwards by 31.4%, with the Russell 2000 Value doing even slightly better at 33.4%. This was a turnaround from earlier in the year when small cap stocks were harder hit from the economic shutdown. With views that the economy will rebound in 2021, small cap stocks would appear poised to do well.

However, if the rollout of the vaccine is slower than expected or the virus mutates and causes more negative impact, the economic picture may not be as rosy as currently estimated, which would likely hurt small cap stocks more than their large cap counterparts.

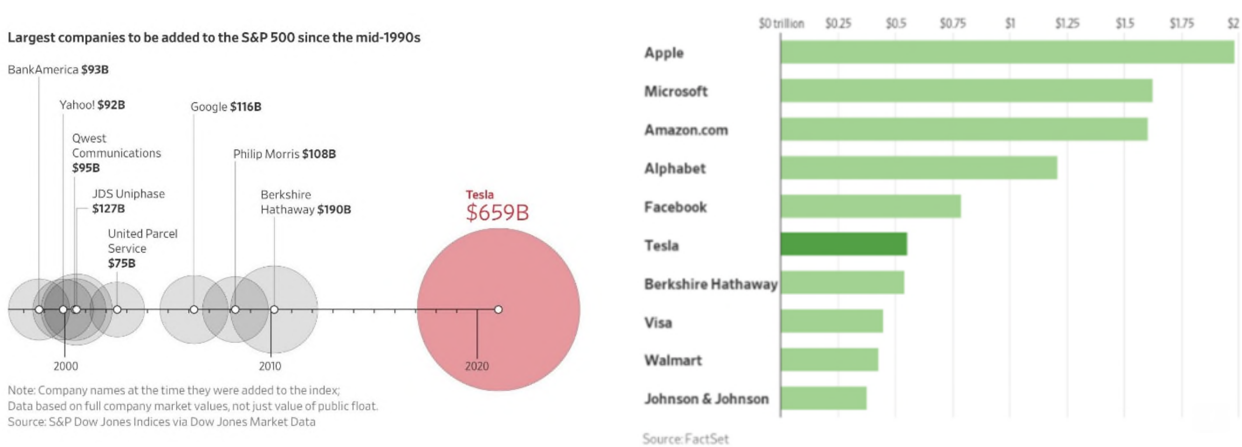
Figure 3: Number of Daily Swings of 2% or More
in the S&P 500



To continue with the rollercoaster theme, the feeling of whiplash, or sudden jolts, is an appropriate one to describe what many of us felt during the year. As Figure 3 shows, the S&P 500 experienced more than 40 daily swings of 2% or more, the most we have seen since the Great Financial Crisis. Going back to 1980, it is easy to see that 2020 was more volatile than the average year.

Speaking of the S&P 500, Tesla became the largest company to ever be added to the S&P 500 when it was included in the large cap index in December 2020 and is already the 6th largest company in the index (see Figure 4).

Figure 4: Size of Companies Added to S&P 500 & Largest Companies



One important point to note is there has been a lot written about large cap stocks in 2020 (e.g. Microsoft, Amazon, Apple, Facebook, Google, Netflix) and how they have thrived during the coronavirus. Interestingly, if we look at the annual returns for 2020, small cap stocks as represented by the Russell 2000 index jumped 20% while the large cap index Russell 1000 performed only slightly better at 21% while the S&P 500 did slightly worse, gaining 18.4%.

Non-U.S. Equity

Like U.S. equities, international equities were also mixed in October with developed markets seeing negative returns with emerging ones being positive. November and December followed with strong results. For the quarter, developed markets (16.0%), developed small cap (17.3%) and emerging markets (19.7%) were quite strong and even outpaced several U.S. benchmarks.

From a country perspective, Austria (38.7%) led the way in developed markets, though its weight in portfolios is tiny, while some of the countries with the largest exposures in the international markets (Japan, 14.0%; Germany, 12.3%; Switzerland, 8.7%) lagged. In the emerging markets, China remains the largest country exposure in most indexes, but generated a lower return (11.4%) than the index for the quarter. At the same time, other large country exposures like India (20.9%), Taiwan (22.1%) and Brazil (36.4%) outperformed the overall emerging market index.

One reason for positive international equity returns has been the declining dollar, something we have been talking about for some time. For the quarter, the dollar trended down vs. a basket of other currencies, which has benefited non-U.S. stock returns. In fact, currencies from Hong Kong, Saudi Arabia, Peru and Argentina were the only currencies to depreciate vs. the dollar for the quarter.

Global Real Estate

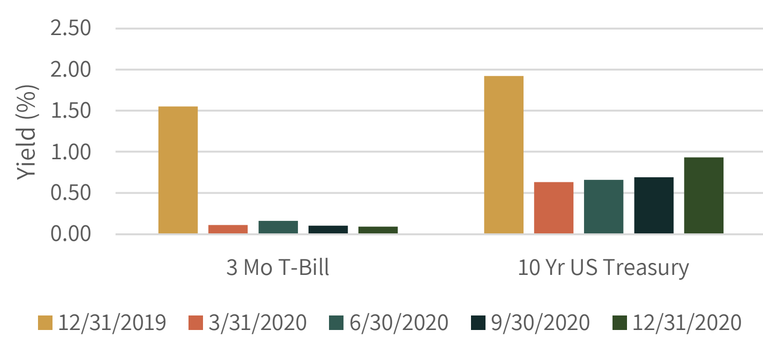
Global REITs, as represented by the Dow Jones Global Select REIT, generated a 13.6% return for the quarter, with non-U.S. REITs (15.1%) outperforming U.S. REITS (13.6%). However, for the year, global REITS did not bounce back as quickly as other equity assets and had negative returns for the year.

Remember, most REIT mutual funds and ETFs include a diversified set of properties like office and residential buildings, cell towers, data centers, warehouses and storage facilities, which may react differently to market conditions. To show specific examples, some of the largest REITs performed quite differently during 2020 including Prologis (14.4%), Digital Realty (20.3%), Simon Property Group (-38.7%), and American Tower (-0.4%).

Global Fixed Income

Fixed income indexes were mostly positive for the quarter with only intermediate and long-term Treasuries generating a negative return.

Figure 5: Interest Rates

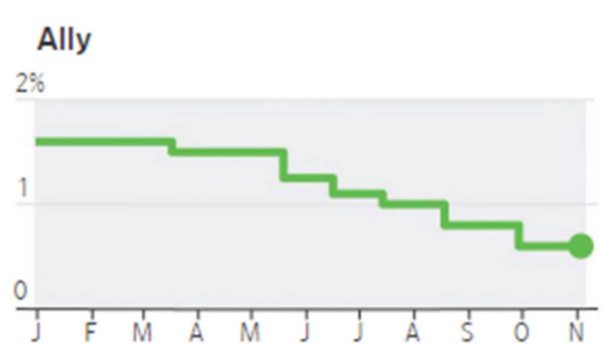


Source: Treasury.gov

One of the most popular questions we receive is what to do with cash with yields so low. The unfortunate answer is there is not much you can do if you are really looking for the safety of cash. As Figure 5 shows, the 3-month T-bill fell significantly during Q1, as the Fed lowered the Fed Funds rate near zero as part of their accommodative policies to support the economy. With the Fed openly stating they do not expect to raise rates again until we reach both maximum employment and maintain 2% inflation, it may be several years before short term rates rise (we said last quarter the Fed is not currently thinking about raising short term rates until 2023).

A common option is to place cash with an online savings account. However, do not be surprised if the online savings accounts are not offering a tremendous yield either, as the banks will follow prevailing market rates. As Figure 6 shows, Ally, an online bank known for offering relatively strong rates, consistently lowered its rate throughout the year.

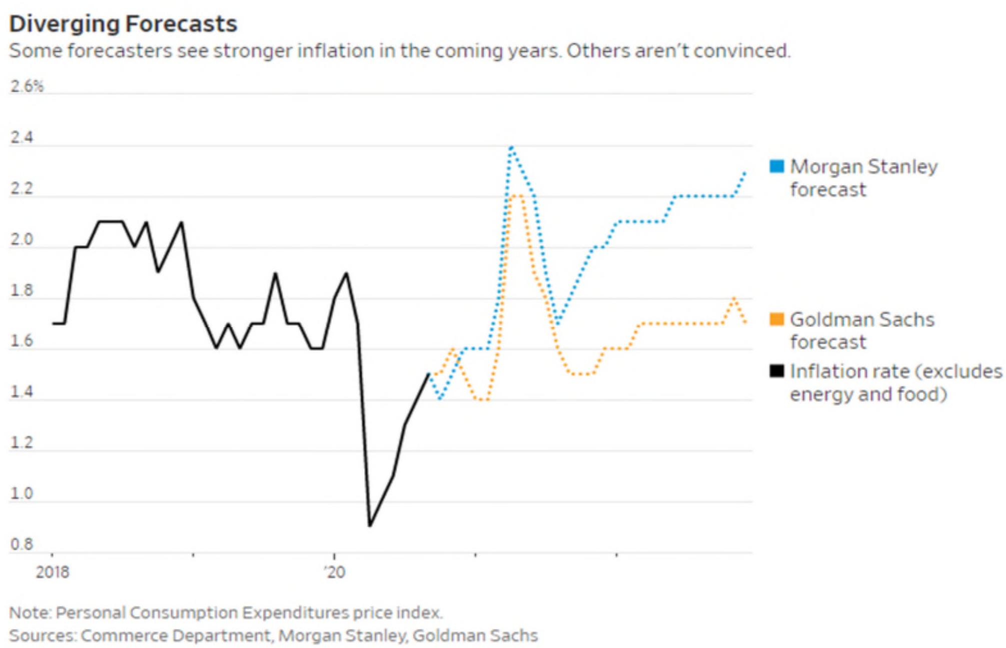
Figure 6: Savings Account Yields



Source: Bankrate.com, as of Nov 3, 2020

Going back to Figure 5, while the 10-year Treasury has generally drifted upwards this last quarter, there has been more volatility intra-month with news of the election and the vaccine playing significant roles. Even with the 10-year Treasury yield increasing towards the end of the year, it ended 2020 at 0.9%, its lowest calendar year close ever and a full percentage point lower than where it ended 2019. Remember, prices move inversely from yields and bond yields may move higher with more government spending, as it tends to boost growth and inflation.

Figure 7: Forecasts



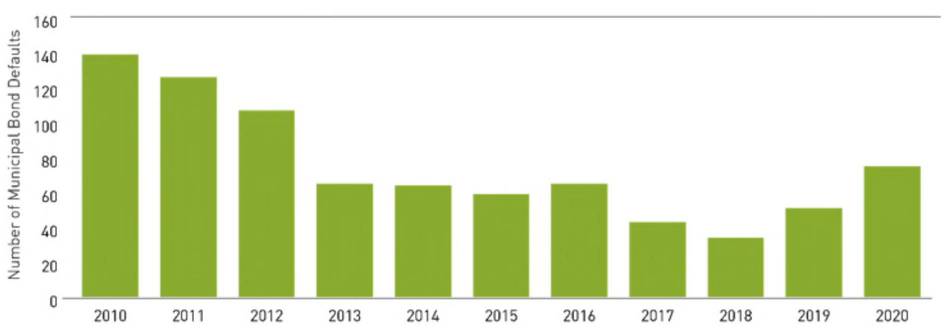
Speaking of inflation, it is something we have been spending a lot of time on lately and have addressed in previous quarterly commentaries. Frankly, there are very valid reasons why we may or may not see higher inflation. To be clear, economists cannot agree on how they view inflation with some forecasters expecting stronger inflation than others (see Figure 7).

As we think about inflation, TIPS are thought of as the best hedge against inflation as the securities are literally tied to CPI, a broad measure of inflation. Some of the reasons why some inflation protection and an allocation to TIPS may be warranted today include: 1) the Fed has stated their inflation target is an *average* of 2% and not a 2% *target* as it previously was, which means inflation could be above 2% for a while, 2) a surge in economic activity could lead to an inflation surprise. On the flipside, there are also reasons why an inflation hedge and a TIPS allocation may not be needed: 1) for investors that have substantial equity positions, it is generally believed that equities will outpace inflation over time, 2) TIPS perform relatively poorly when real yields rise, 3) TIPS are seen as being tax inefficient.

As we discussed in previous quarters, in order to generate more return, investors need to assume more risk. In fixed income, that means either extending duration or lowering credit quality. There are tradeoffs that have to be weighed very carefully before implementing either strategy. From a duration standpoint, extending duration too far out can be a risky move in a period of rising rates. Similarly, lowering credit quality means investing in high yield, or junk bonds, which generally correlate much more with equities and therefore don't provide the diversification benefits we expect from fixed income.

Municipal bonds generated positive returns across the curve both in Q4 and for the year. Like other investments, municipal bonds were also impacted in 2020 by Covid-19, through lower or lost revenue. For example, certain municipal revenue bonds such as airports, toll roads and higher education systems felt greater impact from the virus than say, essential service revenue bonds (e.g. water and sewer) or even general obligation (GO) bonds (i.e. bonds backed by the revenue of the issuing municipality).

Figure 8: Number of Municipal Bond Defaults by Year



Source: Municipal Market Advisors, and Breckinridge Capital Advisors, Inc. (Dec. 2020).

On a positive note, as shown in Figure 8, there were only 75 municipal defaults through mid-December 2020; and while that is above trend for the last few years, it is well below the defaults experienced after the Great Financial Crisis. When investing in municipal bonds, our focus tends to be in short to intermediate, high-quality bonds, which generally have a lower probability of default.

We continue to view fixed income as a method of reducing overall portfolio risk (as measured by standard deviation), given that equities are expected to have much higher volatility. Our portfolio's focus will continue to be on high quality bonds with an emphasis on short to intermediate duration government and corporate bonds, where default risk has historically been relatively low. For some investors, muni bonds are attractive for their tax-free income.

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