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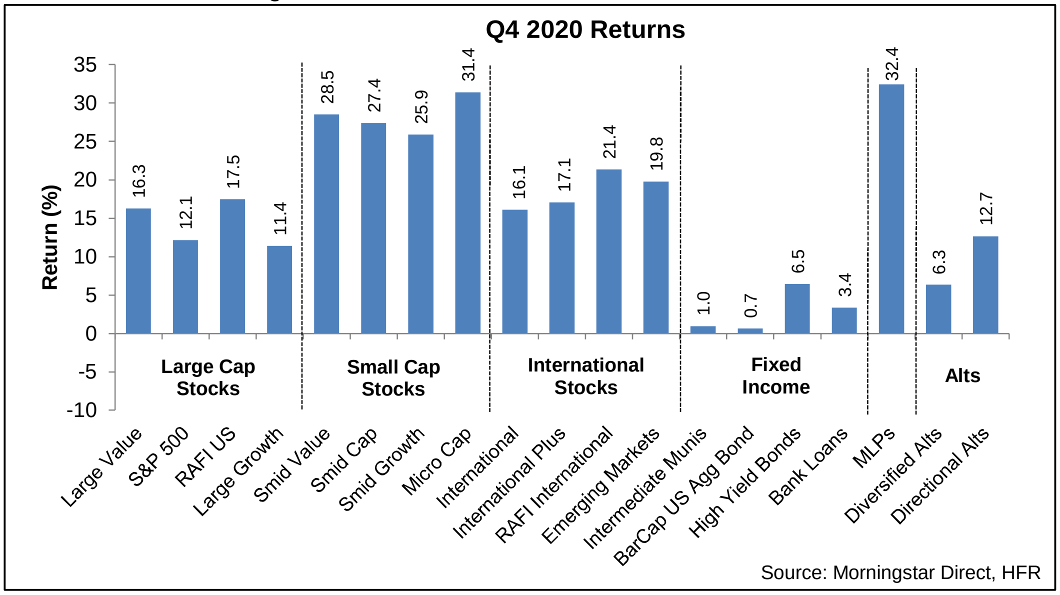
Fourth Quarter 2020 Investment Review & Outlook



EXECUTIVE SUMMARY

Q4 2020 Recap:

- Financial markets delivered strong returns across a number of asset classes during the quarter. The S&P 500 pressed on to fresh all-time highs, ending the quarter up over 12%.
- Fading uncertainties around the virus, the US Election, and additional fiscal stimulus propelled markets higher. Cyclical portions of the market that had lagged the broader indices recovered most significantly.
- The rally in bond markets stalled for a second consecutive quarter, as interest rates bottomed and ticked higher through year end.

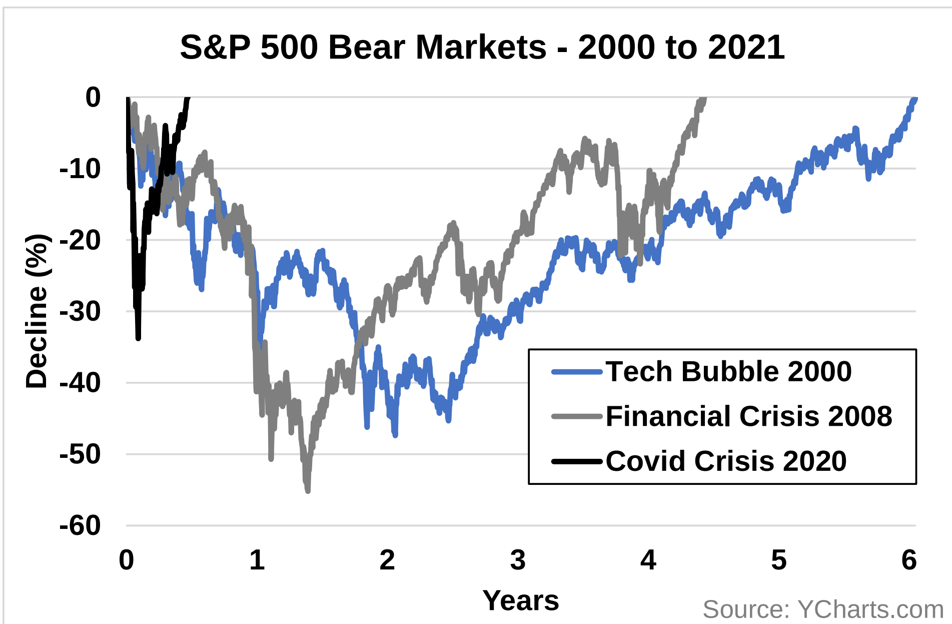
NEXT Outlook:

- As the economy inches back toward full capacity and a new administration prepares additional government stimulus, the risk for higher inflation and interest rates has increased.
- Aggressive Fed policy will support risk assets. However, with market valuations sitting at historically elevated levels, robust earnings growth will need to materialize to support further upside to equity markets.
- While optimism is high for a strong bounce-back in 2021, the pace of vaccinations and a decline in Covid-related lockdowns will be key to a continued economic and market recovery.

To Our Clients and Friends,

2020 will certainly go down as one of the most unique years in modern history – financial markets, the economy, and society at large were completely upended by the effects of Covid-19. The human and economic toll was immense: half a million people in the U.S. died, while our economy shrank by 10% from its prior peak – an astronomical collapse 2.5x the size of the Financial Crisis of 2008. Stock markets, meanwhile, experienced ferocious levels of volatility, swinging by more than 10% a day in February and March and ultimately falling by as much as 34%.

As we have opined here before, those losses would surely have been worse had the Federal Reserve and Congress not acted with such speed and magnitude in March. Some may forget that in 2008, the S&P 500 fell 55% in a decline that unfolded over 18 months. In 2000, the same index fell 47% over a two-year period. It took another three years in each instance for the market to regain its prior highs. This time around, the market's decline was stopped in its tracks in less than six weeks, and recovery to all time-highs was achieved less than five months later. Given the size of 2020's economic decline, this outcome was truly stunning.



Government intervention was, indeed, nothing short of massive. The size of the Federal Reserve's balance sheet nearly doubled, the amount of dollars circulating in our economy increased by 25%, and the fiscal deficit reached 15% of GDP – levels not seen since World War II. At the depths of the pandemic – when even the safest of fixed income investments were unraveling – the Fed resorted to buying a new range of financial instruments we never dreamed possible: investment grade corporates, municipal bonds, asset backed securities, and even junk bond ETFs. Collectively, these actions dwarfed those of 2008, flooding the system with liquidity and setting the stage for an enormous market comeback.

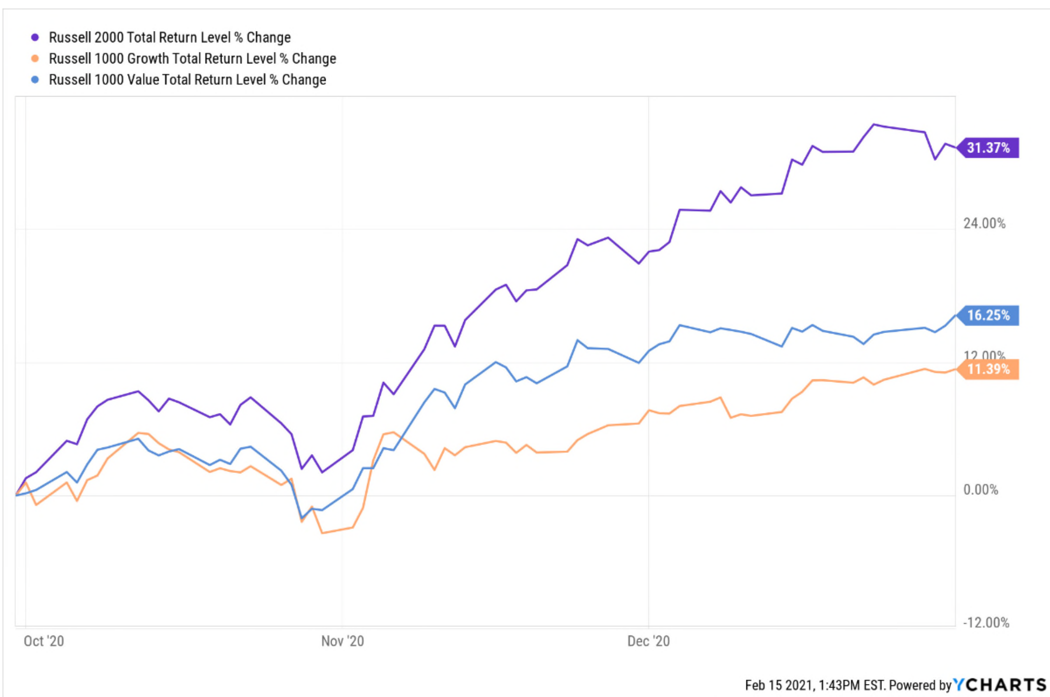
Stock markets began to stall in September and October amid a resurgence in Covid cases and a lack of meaningful additional stimulus. However, the combination of Election Day on November 3rd – whereby Republicans surprisingly outperformed in the Senate races, taking the most extreme agenda items out of play for the new Biden administration – and news of Pfizer's 90% vaccine efficacy on November 9th served as catalysts for a new leg higher. Between November 3rd and year end, the S&P 500 gained 11.8%, but under the surface a more powerful rotation took place. Many of the most beaten down areas of the market, like small cap and cyclical stocks, surged as the market looked toward a re-opened economy.

The end result was a shockingly good year for investment portfolios. Virtually every asset-class ended up in positive territory, crawling back from the destruction of late March. Looking back years from now, 2020's calendar year return will obscure what was one of the wildest and most volatile years in recent memory.

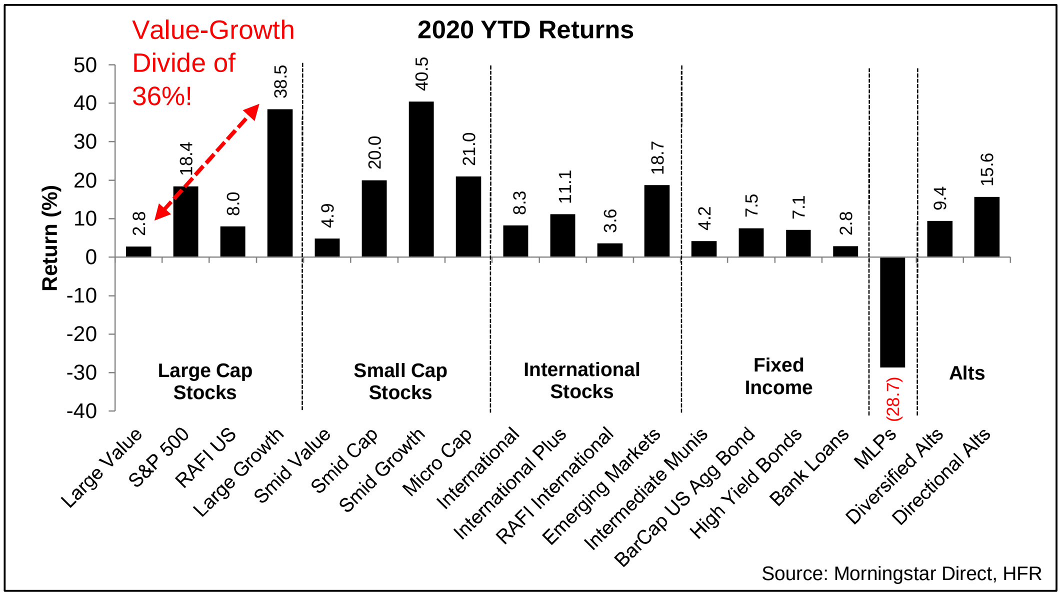
Market Recap…

US large cap stocks continued to move higher during the fourth quarter, benefiting from a stream of positive vaccine news, dissipating uncertainty surrounding the US Election, and expectations for further stimulus. The S&P 500 rose by 12.1%, bringing its full year 2020 gains to 18.4%. As noted above, expectations for a re-opening economy and increased fiscal spending resulted in a sharp rally in cyclical segments of the market – areas that had significantly lagged in the first three quarters of the year.

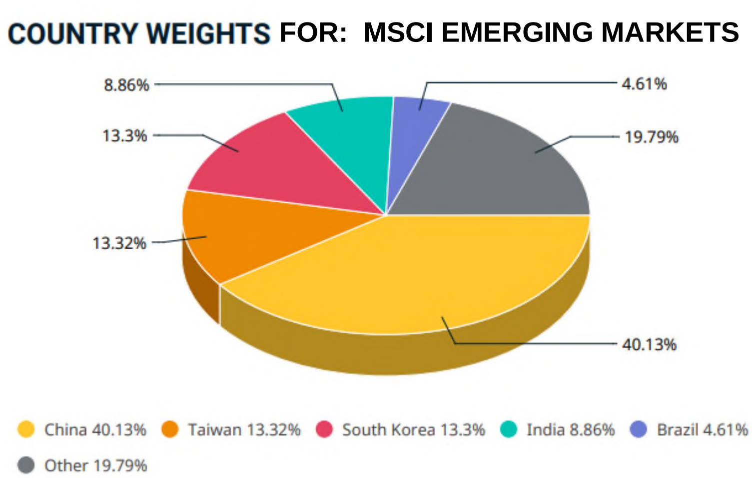
Consequently, value stocks outperformed their growth counterparts with returns of 16.3% and 11.4%, respectively. This was a rare reversal of growth dominance that had persisted in recent years, led by the fortunes of big technology companies. Accordingly, beaten down areas like Energy and Financials jumped sharply in the quarter as they were expected to benefit from a rebounding economy. A similar phenomenon played out among small cap stocks – a notable laggard that was down almost 9% through September 30th. Small caps surged higher by more than 31% in the fourth quarter alone!



For the year, however, those segments maintained significant underperformance. Small caps and value stocks, areas that we would suggest are more representative of the "real economy," eked out slightly positive gains after their fourth quarter rally. However, accelerated adoption of work-from-home technologies and e-commerce drove significant gains in sectors like Information Technology, Consumer Discretionary, and Communication Services (areas heavily skewed towards names like Apple, Microsoft, Amazon, Facebook, and Alphabet). Those three sectors alone accounted for over 80% of the S&P 500's 2020 return and boosted the growth index to a massive 39% gain for the year. The resulting dispersion between sectors and style indices was among the largest on record, and proved to be a fertile environment for many of our active managers.

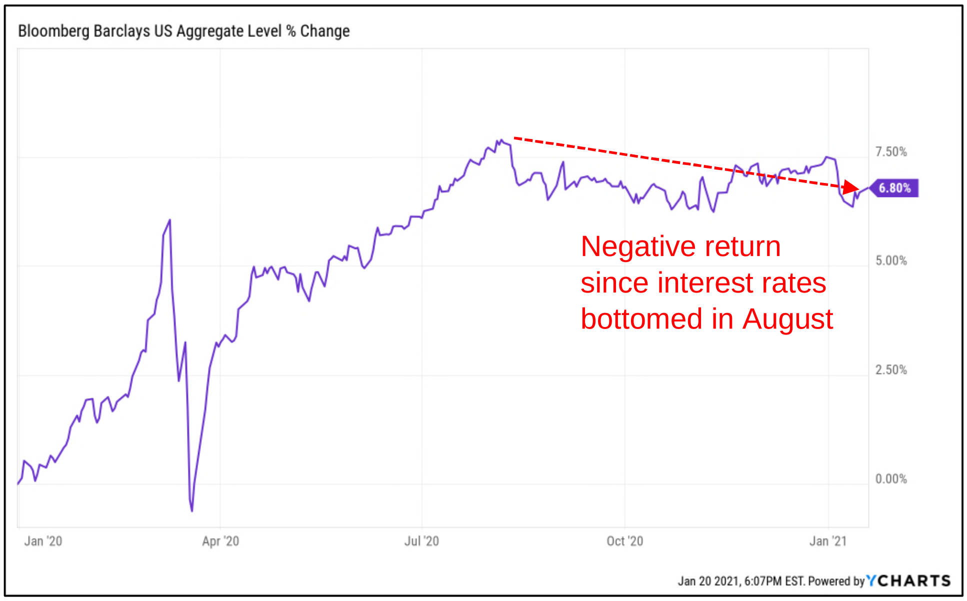


Emerging Markets ("EM") led all regions with returns of almost 20% in Q4, its second straight quarter of outperformance. While China propelled this index higher in the first three quarters of the year, previously underperforming markets in Latin America and Eastern Europe rebounded strongly in the final three months of the year. We expect that EM will continue to benefit from the strength of the recovery in East Asian economies and weakness in the US Dollar, which ended 2020 down 5.8% versus a basket of currencies. We also note that this market has transformed dramatically in recent years, with China now comprising 40% of the index and the biggest sector weights being comprised of technology and communication services.



Slightly behind EM, but also outpacing US Equities in Q4, were International stocks which ended the period up over 16%. European markets do not share the same large allocation to technology and communication sectors, and therefore tend to be more value-oriented in nature. While this benefited the region in the fourth quarter, the index underperformed in 2020 with a return of “only” 8.3%. A recovering euro and re-opening economies should prove to a be strong tailwind in 2021.

Fixed income markets posted their own impressive returns for the year, as liquidity and default concerns triggered a flight to safety trade. For the year, high quality bonds led all subsectors with a 7.5% return. As we have noted in the past, however, the miniscule yields provided by these securities leaves little room for future performance. 2020’s returns were fueled by a historic plunge in interest rates that is unlikely to be repeated. This phenomenon played out in the second half of the year, as interest rates bottomed and ground higher, leaving the broad high quality bond index flat during this period.



With respect to other areas of the bond market, non-investment grade sectors such as High Yield and Bank Loans posted strong quarterly returns of 6% and 3%, respectively, after offering little return in the first three quarters of the year. Like the riskier segments of the equity market, credit sectors performed well under the premise that a gradual reopening of the economy will help diminish default risk and improve credit quality. We note that spreads have tightened significantly throughout the fixed income universe since their dislocation in March, likely constraining returns on a go-forward basis.

Alternative Investments ended the year with a good quarter of performance, buoyed by a rebound in undervalued sectors and increased dispersion between securities. Diversified hedge fund strategies ended the quarter up over 6% and finished up 9% for the year. Directional Strategies, meanwhile, which are more equity sensitive in nature, rose almost 13% for the quarter and more than 15% for the year. Both sets of returns were reflective of significant “alpha” produced in the asset class. As we noted in last quarter’s letter, after a long stretch of muted performance in this asset class, we are encouraged for the prospects of these strategies amid elevated equity valuations and low interest rates.

Finally, Private Markets continue to bounce back, albeit in a more lagged manner than the liquid markets. After suffering a 10% decline in the first quarter, Private Equity rose 9% in Q2 and 11% in the third quarter. Private Credit strategies also continued their rebound after a tough start to the year, where they fell 4.8%, with gains of 3.3% and 3.5% in the second and third quarter, respectively. Fourth quarter results are still not available for these groups, but we expect continued positive performance as valuations continue to mark back up.

2021 Outlook…

In many ways, 2021 has brought us a significantly greater amount of clarity than we have had in recent memory:

(1) **Fiscal Stimulus** – the election results imply more fiscal stimulus is forthcoming from a Democratic administration. A $1.9 trillion pandemic relief bill is currently working its way through Congress, and an infrastructure bill is a realistic possibility at this point.
(2) **More Moderate Policies** – the Senate's unexpected 50/50 outcome should thwart the most extreme policies that had been feared by investors before the election. Significant corporate and personal tax increases, nationalized healthcare, and other environmental items that may have been a headwind for corporate earnings are likely to more modest in scope.
(3) **China Trade War** – one of the single biggest sources of uncertainty for equity markets in recent years has been the bombastic and unpredictable nature of our trade negotiations with China. While dissatisfaction with many of China's economic and human rights practices are a bi-partisan issue, we expect a more traditional approach to diplomacy under the new administration.
(4) **Federal Reserve Accommodation** – the Fed has committed to extraordinary monetary policy for at least the next two years, even in the face of inflationary pressures. This ensures that both short-term interest rates, and the Fed's significant bond buying program, will continue to keep financial conditions stimulative.
(5) **Pandemic's End in Sight** – with vaccines being distributed and Covid-19 cases falling precipitously, the most disruptive period of the pandemic appears to be in the rear-view mirror (albeit with some questions about new variants of the virus and the permanency of the vaccines).

Every one of these elements is meaningfully positive for stocks and other risk assets; thus, it is not a big surprise that markets have gotten off to a fast start in 2021. The Fed's position, in particular, has provided a backdrop of support for risk taking (and, frankly, moral hazard) among investors that has persisted since March. We have seen this phenomenon play out in recent months, as virtually every market dip has been relentlessly bid up by market participants. It is hard not to envision this environment persisting – albeit with some likely bumps along the way – for as long as the Fed remains committed to easy monetary policies.

As stewards of your capital, however, we must observe that while these are all encouraging developments for the direction of the stock market, at some point valuations of financial securities must reflect reality – and today, reality is stretched. Stocks, bonds, and credit all trade at or near their most expensive valuations in 20 years. The stock market could drop 22% and it would still only trade at its long-term average of 16x earnings.

Indeed, many of the classic signs of a bubble are taking root. New company listings are up sharply (especially through structures called "SPACs"), IPO performance has been astronomical (companies like Door Dash and AirBNB exploded 80% and 100%, respectively, in their first day of trading), and a massive demand for thematic exposures like electric vehicles and clean energy have made the stock market feel more like a casino than a place where companies and cash flows are valued.

That phenomenon has played out in January, as more headlines were made surrounding the craze over GameStop, a company in secular decline that was bid up more than 2,000%. Retail investors clamored over each other to gain exposure to names like GameStop, AMC, and Blackberry in what can only be described as a speculative frenzy. That story has inevitably come crashing down to reality. For now, the damage remains localized, but we cannot help but wonder whether this is a so-called canary in the coalmine.

Only time will tell whether we are currently in the midst of a bubble – the expansion of the NASDAQ in the late 1990s went on for years before finally collapsing. What we do know is that while bursting bubbles tend to be painful, disciplined investors who remain diversified and do not chase the latest hot dot tend to sharply outperform in those environments.

Note on Inflation and Interest Rates…

With the so-called Blue Wave now firmly in place – Democratic control of the White House, the House, and the Senate – investors are preparing themselves for more fiscal stimulus in the form of direct transfer payments to individuals, support to businesses, infrastructure spending, and more.

More fiscal stimulus, however, on top of the dramatic spending that took place in 2020, has profound implications for inflation and interest rates in this country. With the national deficit sitting at World War II-era levels, and with the vast majority of that new debt being purchased by the Federal Reserve, serious concern is emerging that the rest of the world will lose confidence in the value of the U.S. dollar and that inflation could pick up meaningfully.

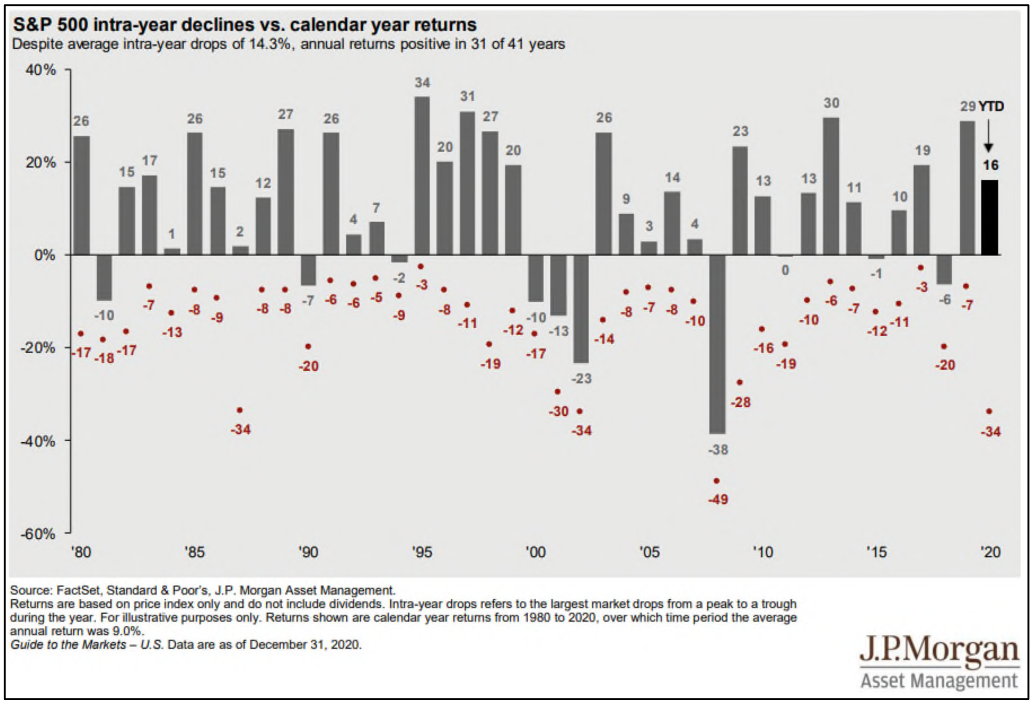
While a small amount of inflation is healthy, rampant inflation erodes individuals' purchasing power. One must only look to battered economies in places like Argentina and Eastern Europe to understand the negative impacts of high inflation. While we are skeptical true hyperinflation will affect the US (especially with the rest of the developed world acting as profligately as we are), there is no question inflationary risks are increasing. The burgeoning performance of assets like gold and bitcoin are direct corollaries to this phenomenon.

One byproduct, however, of even modestly higher inflation – and perhaps a more realistic risk – comes in the form of higher interest rates. Intermediate rates have been on the move in the past six months, rising more than 1.00% since August. That trend has picked up steam in the last few weeks; a continued increase will significantly impact bond market performance (now down 3% for the year) and serve as a major threat to the equity market rally. In a world where many factors have turned positive for the market, the path of interest rates and inflation bear close watching in the months and quarters ahead.

Final Thoughts…

Despite our comments above, we do believe that the environment remains broadly accommodative for investors and we encourage you to stick with your long-term allocations. We have been prepared for rising interest rates for some time by focusing on short duration bond investments – an approach which has played out well so far this year.

As far as the equity markets, we would remind all investors that stocks rarely advance in a straight line. After a period of sustained success in the markets and with a lot of "good news" already priced in, it would not surprise us to see this market take a breather. Indeed, the stock market typically experiences a pullback of at least 7-8% every year (see chart below). Especially in an environment of extended valuations, a temporary market decline should be viewed as a healthy reset, in our opinion.



We hope you and your families have been able to stay safe amid these unprecedented times. If something in your life has changed or you feel your appetite for risk in your portfolio has changed, please reach out to us at your earliest convenience.

Sincerely,

Your Investment Team

2/23/2021

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