Third Quarter 2020 Key Takeaways

Despite some choppiness in September, the S&P 500 Index rose 8.9% in the quarter and has recovered all its losses for the year to end the quarter up 5.46% for the year. Without the FANMAG stocks (Facebook, Amazon.com, Netflix, Microsoft, Apple, and Google/Alphabet), however, the S&P 500 would still be *down* for the year.

Underneath the surface, mega-cap growth names continue to lead the U.S. market. They now dominate the index, but their outsized past returns have come from their ascension to the top, not from owning them once they were already there. Owning the largest stocks has badly lagged owning the diversified index over time.

The U.S. mega-cap growth effect has driven the relative returns of U.S. versus foreign stocks this year. Developed international stocks gained 6.0% this quarter, almost three percentage points behind U.S. stocks, though, emerging-market stocks outperformed U.S. stocks with a return of 10.2%. Both groups still trail U.S. stocks year to date.

Bond markets were calm throughout the summer, thanks in large part to the Federal Reserve's extremely accommodative monetary policy. With Treasury yields unchanged, core investment-grade bonds gained 0.6% in the third quarter.

In riskier segments of the bond market, high-yield bonds and floating-rate loans were each up over 4% for the quarter but remain slightly negative for the year.

Going into the final quarter of 2020, multiple crosscurrents and uncertainties are presenting both investment opportunities and risks.

There are reasons to be cautiously optimistic: An economic recovery is underway. A vaccine is likely in 2021. Monetary policy is extremely supportive. And U.S. stocks in the aggregate are cheap relative to bonds.

There are also reasons for caution: Election uncertainty could cause financial market volatility. A disputed result or ballot-counting delays could mean greater volatility than usual. The pandemic remains a significant societal, economic, and financial market risk. Some segments of the U.S. stock market are very expensive relative to history. And there is always the potential for a geopolitical or other unknown shock.

My watchwords for portfolio construction and positioning remain *balance* and *resilience*. Our portfolios are balanced and diversified across multiple dimensions. And I believe they can provide strong returns in my base-case and more optimistic economic scenarios, while still maintaining resilience should a more challenging scenario play out.

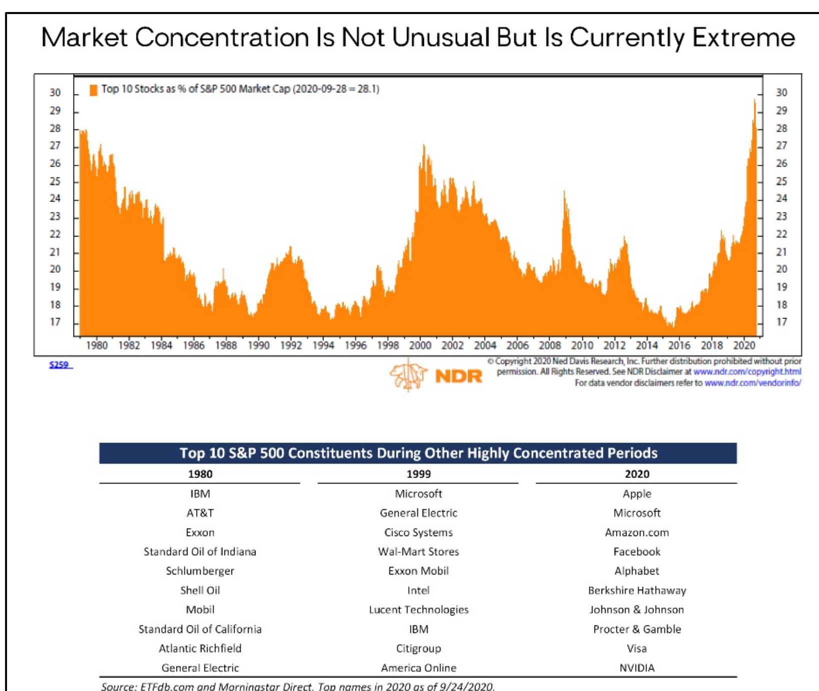
Investing in a way that accounts for the wide range of plausible outcomes requires discipline, patience, and a willingness to stand away from the herd at times. It can feel uncomfortable to stay the course, or add to equities, when markets are plunging or to care about valuation and not chase segments of the stock market higher when they are soaring. But in the end, this is the best approach I've found to achieving one's long-term investment goals.

Third Quarter 2020 Investment Letter

Market Recap

Despite some choppiness in September, equity investors were treated to solid gains during the third quarter. The S&P 500 Index rose 8.9% in the quarter and has recovered all its losses for the year. Smaller-cap U.S. stocks posted a return of 5.0% but remain negative year to date (iShares Russell 2000 ETF).

However, beneath the market surface a major bifurcation remains. The mega-cap growth names continue to lead the market. The often-referenced FANMAG group of stocks (**Facebook**, **Amazon.com**, **Netflix**, **Microsoft**, **Apple**, and Google-parent **Alphabet**) are up an astonishing 42.5% year to date on a price basis. The price return for the S&P 500 is 4.1%. And excluding the FANMAG stocks, the other 494 names have a 3.6% price *loss* year to date (numbers from NDR—Ned Davis Research).



Top 10 S&P 500 Constituents During Other Highly Concentrated Periods

1980	1999	2020
IBM	Microsoft	Apple
AT&T	General Electric	Microsoft
Exxon	Cisco Systems	Amazon.com
Standard Oil of Indiana	Wal-Mart Stores	Facebook
Schlumberger	Exxon Mobil	Alphabet
Shell Oil	Intel	Berkshire Hathaway
Mobil	Lucent Technologies	Johnson & Johnson
Standard Oil of California	IBM	Procter & Gamble
Atlantic Richfield	Citigroup	Visa
General Electric	America Online	NVIDIA

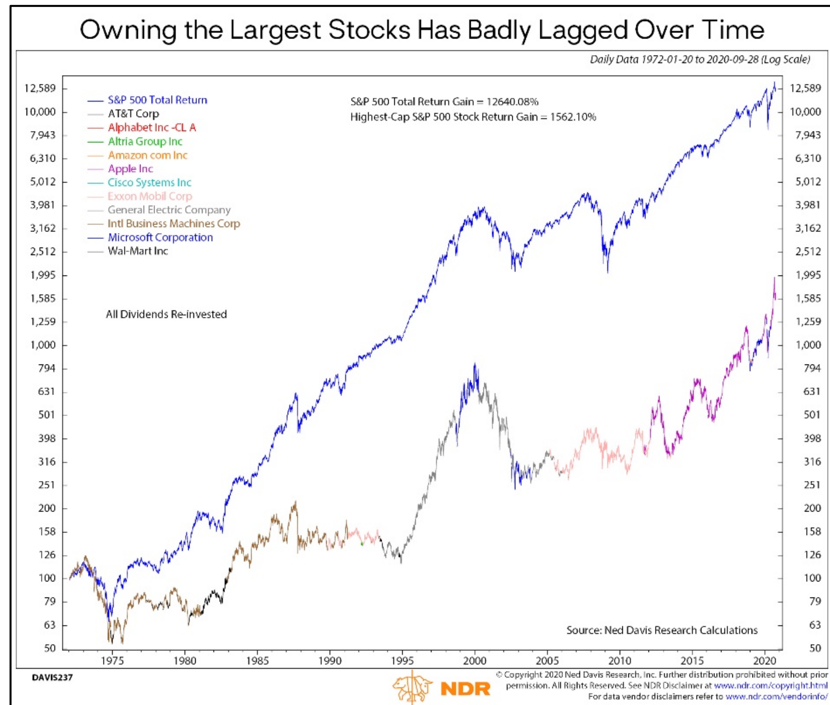
Source: ETFdb.com and Morningstar Direct. Top names in 2020 as of 9/24/2020.

The outperformance of these top index names means concentration within the index has soared to record highs. The top 10 stocks in the S&P 500 make up a record 28% of the total market cap of the index (see NDR chart to the right). But the top names in the index have constantly changed throughout history. Back in the 1980s, oil and gas companies dominated the top 10 in the S&P 500. In the late 1990s, it was technology companies that held the top position (but Microsoft is the only one still in the top 10 today). Today, the FANMAG stocks are in the pole position.

It's not out of the ordinary for a handful of companies to make up a significant percentage of the index. But keep in mind that these companies' outsized past returns have come from their ascension up the market cap spectrum, not from owning them once they are at the top of the mountain. The NDR chart at the bottom of the next page shows that owning just the largest stock in the S&P 500 would have dramatically underperformed holding the diversified index over time.

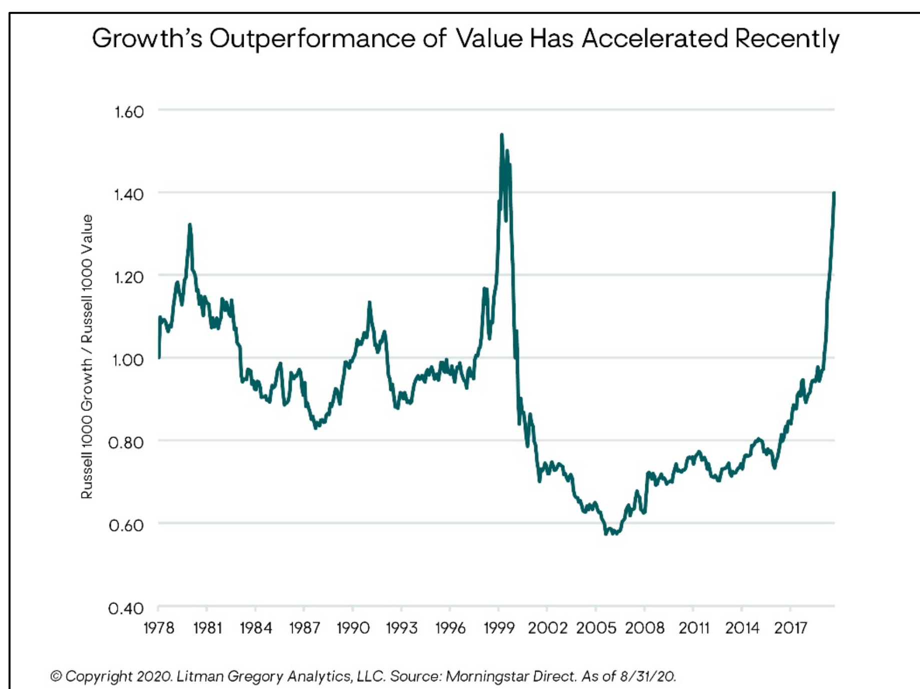
The strong outperformance of growth and technology names relative to cheaply valued and economically sensitive stocks continues. The six FANMAG stocks are nearing a 40% weight in the Russell 1000 Growth Index, whereas the Russell 1000 Value Index is much more diversified. For example, 40 names make up 40% of the value index, and it and does not benefit from a handful of strong companies driving the index higher. This will (eventually) cut both ways. But in the meantime, the outperformance of growth that started in 2007 has accelerated at a pace not seen since 1999–2000.

This is not to suggest the current group of growth companies is comparable to what happened during the dot-com bubble. The valuations may be nearing similar heights; however, the fundamentals are not the same. The current firms have created economic value, grown revenues at astonishing rates, established new markets, and disrupted old players. And in an environment where growth has been scarce with interest rates at all-time lows, investors have been willing to pay up for that growth.



The mega-cap growth effect is not only driving the returns of growth versus value in the United States, but also the relative returns of U.S. stocks versus foreign stocks. For the third quarter, developed international stocks gained 6.0%, almost 300 bps behind U.S. stocks (Vanguard FTSE Developed Markets ETF). However, emerging-market stocks outperformed U.S. stocks with a return of 10.2% (Vanguard FTSE Emerging Markets ETF).

Year to date, the 11% outperformance of larger-cap U.S. stocks relative to foreign stocks (represented by the MSCI ACWI ex USA Index) can be attributed to the mega-cap growth stocks. For the year, the MSCI ACWI ex USA has lost 5.4% while the S&P 500 Equal Weight Index (which assigns the same weight to each stock in the index whereas indexes like the S&P 500 weight companies by their market value) has roughly the same performance with a 4.7% loss. Meanwhile, the market-cap-weighted S&P 500 is up 5.6% this year.



Bond markets were calm throughout the summer, thanks in large part to the Federal Reserve's extremely accommodative monetary policy. Treasury yields were unchanged, and core investment-grade bonds gained 0.6% in the third quarter. Fed officials say they are now targeting "average inflation" of 2% and have signaled that they do not expect to raise rates at least through the end of 2023. Since inflation has not topped the Fed's target in a decade, many market participants

expect low rates and supportive policy to continue for a long time. In riskier segments of the bond market, high-yield bonds and floating-rate loans were each up over 4% but remain slightly negative for the year.

Going into the final quarter of 2020, multiple crosscurrents and uncertainties are presenting both investment opportunities and risks, over the near term and medium to longer term. A unique U.S. election approaches in November. The market doesn't like uncertainty, so the weeks leading up to the election and afterward may be volatile. But history shows any election-year declines are usually short-lived and the political party in power is not a significant driver of investment returns. Political views have no place in my investment process, and I don't attempt to predict the short-term market reaction to elections (or any short-term event). There are simply too many *other* factors that impact markets over time. Instead, I stick to my longer-term analytical framework in which I consider and weigh multiple macro scenarios and assess the potential risks and returns for numerous asset classes and investments in each scenario. The fundamentals are what really drive long-term market performance.

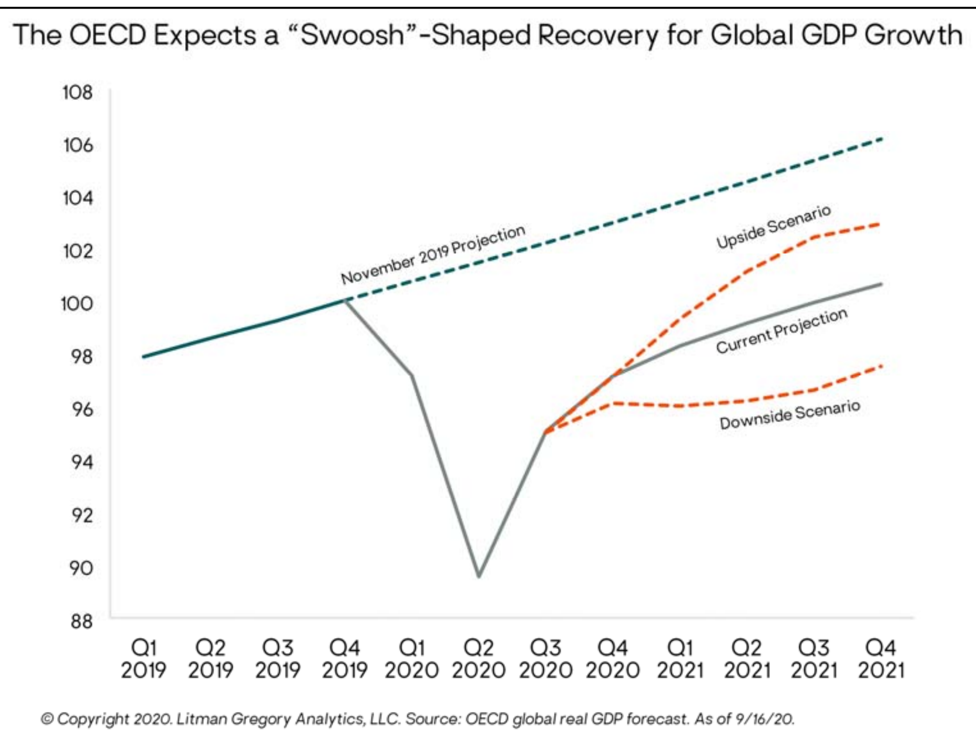
Looking through the election, there are reasons to be cautiously optimistic about the investment prospects for global equities and corporate bonds. And there are reasons for caution.

Current Macro & Market Outlook: Reasons for Caution, Reasons for Optimism

As is typically the case, my market crystal ball is foggy, with multiple crosscurrents and uncertainties presenting both investment risks and opportunities, near term and medium to longer term. Below, I highlight some key reasons for caution and other reasons for cautious optimism. I conclude with a discussion of portfolio positioning and the need for balance given this backdrop.

Reasons for Optimism

An economic recovery *is* underway. Economic data and forecasts are improving (see the growth projections from the Organization for Economic Co-operation and Development, or OECD, in the chart to the right). All else equal, rebounding economic growth here and abroad should support equity and corporate bond markets.



On the virus front, the speed of progress in vaccine development is promising. An effective and widely distributed vaccine would allow economic activity to return to its full pre-pandemic potential.

And this year's extraordinarily supportive monetary policy (asset purchases and lower interest rates) and huge fiscal stimulus, both here and abroad, were key drivers of the speedy recovery in markets and the global economy. Central bank actions and government spending don't *guarantee* the absence of volatility, another bear market, or recession.

But there are programs now in place, especially in the United States, that could step in to help the functioning of markets and the economy in case volatility returns or setbacks occur.

Reasons for Caution

It remains to be seen how strong the actual economic recovery is and how much of it is already discounted in current prices. In my view, there is as much room for disappointments as there is for positive surprises.

While vaccine development steams ahead, the potential remains for a large resurgence of COVID-19 in the fall and winter months. We are seeing this already in Europe, and the infection rate has popped up slightly here in the United States recently. This raises the risk of renewed shutdowns and another economic downturn.

Monetary policy is supportive, but more fiscal support from Congress is likely needed to further protect citizens, help businesses survive, and shore up state finances. If it doesn't happen, it will be a hit to fourth quarter economic growth, which could in turn impact markets.

Uncertainty around the upcoming election and the possibility that the final result could be delayed for several days, weeks, or even months. Even absent a disputed election result, the weeks leading up to election day are likely to be volatile. The fiscal and economic policy implications between a President Donald Trump or a Vice President Joe Biden victory are meaningful, particularly if the Democrats sweep Congress. For example, a Democratic sweep raises the likelihood of corporate and/or capital gains tax increases—market-unfriendly policies. On the other hand, the economy may get a near-term boost in a Biden administration from increased fiscal stimulus (e.g., extended unemployment benefits and infrastructure spending) as well as the potential for a reduction in trade tensions and tariffs relative to a Trump administration.

Finally, there is always the potential for a negative geopolitical shock. The U.S.-China conflict and Brexit come to mind, but a new development could emerge that no one is considering (like the pandemic did earlier this year).

Portfolio Positioning

I am very comfortable with how our portfolios are constructed, as detailed below. The watchwords of current portfolio positioning remain *balance* and *resilience*. Portfolios are balanced across multiple dimensions: domestic versus international stock exposure, growth versus value strategies, interest rate risk versus credit risk, traditional versus alternative investments. And I've designed our portfolios with the goal of generating potentially strong returns in my base-case and more optimistic economic scenarios, while maintaining resilience in a more challenging scenario.

On the equity side of our portfolios, despite an April 2020 shift from international to U.S. stocks, our portfolios remain underweight to U.S. stocks (relative to international and emerging markets stocks combined) due to unattractive relative valuations for U.S. stocks. In April, after an initial large decline, I added to U.S. equity exposure at more attractive prices. Since that time, U.S. stocks have appreciated strongly, outperforming most other investments. They have soared more than 50% from the March low and again look historically overvalued. For stocks that have prospered during the pandemic, forward price-to-earnings (P/E) and median P/E ratios are approaching dot-com-bubble highs. Of course, nothing prevents valuations from rising even further near term, but we know high starting point valuations have a strong *inverse* relationship with future long-term returns. Overvaluation tends to not matter … until it does.

But while U.S. stock valuations look expensive relative to history, they look cheap relative to bonds. Bond yields are extremely low, which forces investors to allocate more to stocks, pushing stock valuations even higher or keeping them higher for longer. Cheap *relative valuations*, in addition to a supportive Fed and plausible optimistic scenarios in which U.S. stocks *can* deliver decent returns, keep me from reducing exposure to U.S. stocks in favor of bonds. I don't want portfolios to be too underweight to U.S. stocks as there could be a significant opportunity cost if they continue to perform well.

An overweight to emerging-market stocks offsets some of the underweight to U.S. stocks. And portfolios are moderately weighted to developed international stocks. We continue to see superior five-year expected returns for emerging-market and developed international stocks across most forecasted economic scenarios. Stocks being cheap compared to bonds is even more true in international markets, where sovereign bonds from some countries are producing negative yields. Plus, in a sustained global economic recovery with Fed-repressed U.S. interest rates, the odds are that foreign currencies will appreciate against the U.S. dollar. This would further enhance the returns of international assets for U.S. dollar–based investors.

To better diversify our fixed-income allocations, in July 2020 we added intermediate and long term high-quality corporate and government bonds to most portfolios. Core bonds, as they are referred to, are an important shock absorber in the event of a negative economic or geopolitical shock. Adding core bonds is tantamount to buying an insurance policy to protect against a decline in stock prices. However, as mentioned before, yields are very low and even a modest increase in interest rates could lead to negative short-term returns from core bonds, essentially the price we may potentially pay for our insurance policy.

The third broad component of our balanced portfolios comprises alternative investment strategies. It's important to understand that this component of the portfolio is less a different investment *vehicle* than it is a different investment *strategy*. In July 2020, we replaced the Litman Gregory Alternative Strategies fund with the J.P. Morgan Hedged Equity fund. The J.P. Morgan fund aims to invest 100% in U.S. stocks and use call and put options to limit the fund's loss in any quarter to 5%, for quarters when the S&P 500 suffers a loss of up to 20%. This strategy results in a smoother ride than a long-only equity investing strategy, and avoids the interest rate risk of investing in bonds, but it does give away some of the upside of investing in stocks. Alternative investment strategies further diversify equity and bond market risk and are intended to generate returns over time that are much better than we expect from core bonds and potentially competitive with equity returns. In a bull market, these alternative strategies will likely trail stocks. But in a sustained bear market, we expect them to provide protection and potentially offset losses in risk assets.

Closing Thoughts

History shows that markets are consistently unpredictable. Adding to the uncertainty are the unprecedented circumstances, challenges, and structural changes the global economy is currently facing.

Having a high degree of conviction in any single outcome strikes me as imprudent. Instead of trying to continuously predict the future, I am focused on building resilient portfolios across multiple plausible scenarios, accounting for a range of shorter-term risks but keeping the primary focus on the medium- to longer-term fundamentals that ultimately drive investment returns.

Investing this way requires discipline, patience, and a willingness to stand away from the herd at times. It can feel uncomfortable to stay the course, put capital at risk when markets are plunging, or refrain from chasing overvalued markets higher when they are soaring. But in the end, this is the best approach I've found to achieve long-term investment goals.

Best,

Kelly D. Kane, ChFC, CFP