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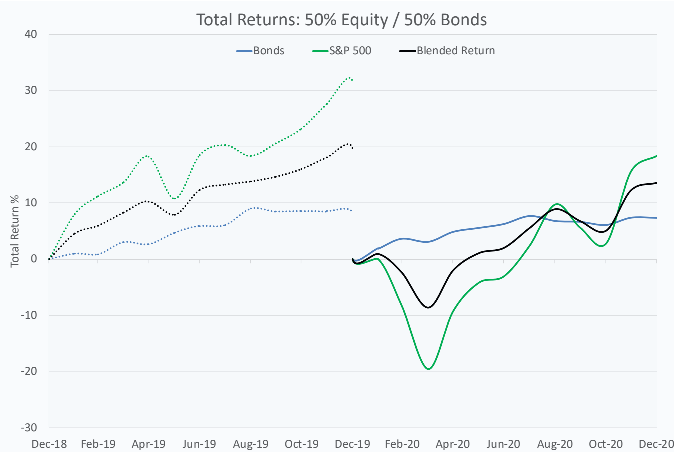
WHERE WE STAND – Q4 2020

The S&P 500 Total Return Index was up 12.15% (including dividends) in Q4 2020. See the solid green line to the right in the chart below. The Aggregate Investment Grade Bond Index (including interest) was unchanged for the quarter (blue line). If your portfolio comprised 50% S&P 500 and 50% Bonds, your YTD return would be 13.6% (black line). Data for 2019 is shown, broken lines, to the left.



Overview

The S&P 500 index was up 11.7% in the 4th quarter, to new all-time highs. See the chart below. After uncertain back and forth price action in October leading into the general election, the broader equity market received a

boost in November from two sources. First, Republicans, kept their majority in the US Senate in the election, undermining the potential for President-elect Biden to implement his campaign promise of raising the corporate tax rate as a start to addressing distribution of wealth issues. Second, the announced development and subsequent FDA approval of an effective coronavirus vaccine which promises to help economic recovery in 2021. Of course, providing the bullish backdrop, is a) the ongoing commitment of the Federal Reserve to keep policy interest rates at near zero for the foreseeable future and b) the ongoing, deficit financed, fiscal aid from the federal government. Investors, for now, are focusing on searching for yield in financial assets, even in the face of now-excessive valuations. Of note: the most buoyant assets recently, like Nasdaq 100, only has a yield of 0.5% and a very lofty PE Ratios of 34x. Investors are choosing to disregard the implications of these valuations for generating future risk-adjusted returns; the longer-term consequences of an unprecedented run-up in fiscal deficits by the US Treasury; and the possible effects of unprecedented money creation by the Federal Reserve. Animal spirits are running rampant.

2020 saw a bifurcated equity market performance: a clear distinction between winners and losers based on which companies benefited from the pandemic in the plus column versus those hurt by the implications of quarantine and work(and play)-from-home in the negative.

But, in an attempt to understand overall valuations, let's look at data for the whole S&P 500. When the virus began in, say, December 2019/January 2020, the expectation for 2020 S&P 500 earnings was for ~$182 per share. An increase of 14.6% over 2019 earnings of $157.The index, trading at around 3,200 was therefore valued at (3,200/$182) 17.5x forward earnings.

As it turned out, earnings for 2020 will be only $120 per share, a decline of 23.5% from 2019.

At the same time (just before the virus manifested, forecasts for 2021 earnings were for $195 per share. Now, forecasts for 2021 earnings are $166 per share, up

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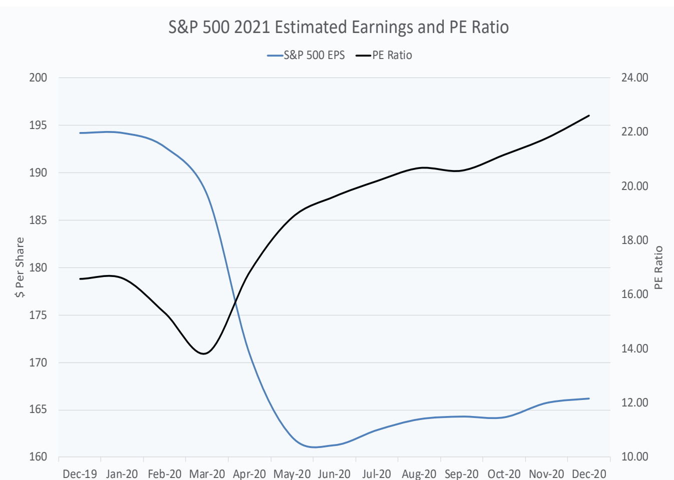
a substantial 38% from 2020, but still 15% below the forecasts at the beginning of this year. Notwithstanding these lower earnings forecasts, the S&P 500 has traded higher, to now a forward valuation of (3,756/$166) 22.6x forward earnings.

It's fair to say, that therefore, all the price appreciation in the equity market in 2020 is due to multiple expansion and not earnings growth. In fact, the last 3 years of equity appreciation has been largely due to multiple expansion then earnings growth. This recent multiple expansion is justified to some extent by the fall in interest rates, which gives a boost to valuation metrics.

The chart below shows how the year progressed in terms



of valuation. The blue line shows expectations for S&P 500 earnings for 2021: how they collapsed in early 2020, and the gradual, marginal, recovery since. The black line shows the forward PE ratio: how it fell to ~14x earnings in early March (a true buying opportunity and value proposition) and how it has moved to over 22x earnings: full/excessive valuation by the end of the year.

Implicit in these valuations are the expectation for a marked improvement in the economy in 2021 and beyond, continued low inflation (notwithstanding the explosion in money supply) and ongoing investor exuberance.

Where We Stand

We have navigated the challenges that the turbulence of 2020 presented to us by adhering to our value principles. We entered the year with capital preservation as a priority and therefore avoided any meaningful drawdown in the broad, 35% sell-off in Q1. Instead, we were in a position to add to portfolio holdings in the value space and shift our emphasis more to capital appreciation. We lightened up our holdings in the summer, and then added to value type equities leading into the general election.

We continue to manage our portfolios cognizant that we are in unchartered waters in regard to macro balances in the world economy and late cycle in terms of equity valuations and investor over-exuberance.

Valuations and an overabundance of speculative activity in the equity and fixed income markets (Robinhood traders day trading; pockets of speculation and bubble-like behavior in call options, SPACs, IPO's and tech stocks; and various other measures like a lack of short interest, completely compressed junk bond spreads) are warning us against having an over-exposure to risk assets in our portfolios.

We are managing to compound the growth in our portfolios year after year whilst having an appropriately lower risk profile.

What of 2021 and beyond? With fixed income markets so fully valued, forward returns from bonds are likely to be scant, unless there is a collapse in equity markets that creates a flight to quality in government bonds. Similarly, equity market returns in general promise to be contained, since so much has been borrowed from the future in this year's equity recovery off the lows. Returns will diverge between growth and value, but we are hopeful that value will prevail given the current fairer valuation relative to growth stocks.

As we enter 2021, we have the usual uncertainty that investors always face, but less margin for error given how full valuations have become and how serious monetary and fiscal imbalances have been created.

Once the Georgia election run off has been decided tomorrow (an event that could completely change the existing investment narrative), we expect a transition to a new Presidential policy environment will unfold. During the coming year we will adapt from a quarantined world

to a more normal one, with outcomes that are for now unclear in terms of economic growth and inflation outcomes.

Our portfolios are structured to benefit from a positive outcome for equity prices, albeit with a lower risk profile than the overall market. We plan to take advantage of volatility if it presents itself, in an effort to maximize portfolio returns, but for now have again shifted our bias somewhat towards capital preservation, knowing that in the future there will be better opportunities to deploy capital more aggressively.