CAPITAL STRATEGIES
FINANCIAL CORPORATION
Navigating Financial Security

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Financial Markets Commentary 4th Quarter 2020

Summary

The stock market's recovery from the COVID-influenced market sell-off in March accelerated last quarter as multiple pharmaceutical companies announced successful vaccine trials. This news enabled investors to put a timeline on a return to normalcy. They responded by shifting some of their assets away from firms that were doing well in the pandemic to those businesses that should profit most from the pandemic being over. As a result, "value" as an investment discipline actually outperformed "growth" in the fourth quarter by 16.2% to 11.4% (fn-1), though the full year results remained lopsidedly in growth's favor (38.5% to 2.8%). Energy and financial services were the strongest sectors of the market last quarter gaining 27.8% and 23.2% (fn-2) respectively, but neither managed to break even for the full year 2020. Technology's middle-of-the-pack 11.8% return kept it in first place for the full year with a 43.9% gain. Investors have made technology easily the largest of all the eleven sector groups.

With a late surge, emerging market stocks just about equaled the S&P 500's 18.4% (fn-3) 2020 gain. China led the major EM countries with a 29.5% gain for the year, but like the U.S. tech sector tapered off in the fourth quarter as EM investors shifted to Latin America and India. Developed foreign markets trailed the U.S. for the year but outperformed it in the fourth quarter. Both Europe and Japan gained over 15% in the final quarter compared to the S&P 500's 12.2%. The dollar was very weak in the fourth quarter, which almost always really helps foreign market performance.

The U.S. bond market returned a very strong 7.5% (fn-4) last year as yields plunged in response to the Federal Reserve's efforts to prop up the COVID-ravaged economy. Only 0.7% of that return came during the fourth quarter, however. Bond yields bottomed in late summer and rose modestly thereafter such that long term Treasury bonds actually declined in price in the fourth quarter. The exception was inflation protected bonds (TIPs) which responded well to the fear that all the monetary stimuli would eventually prove inflationary. TIPs were the best segment of the bond market in 2020, gaining 11.0%. Investment grade corporate bonds were a close second at 9.9%. High yield corporate bonds were the best performing segment of the bond market last quarter, rising 6.4%. They finished the year up 7.1%.

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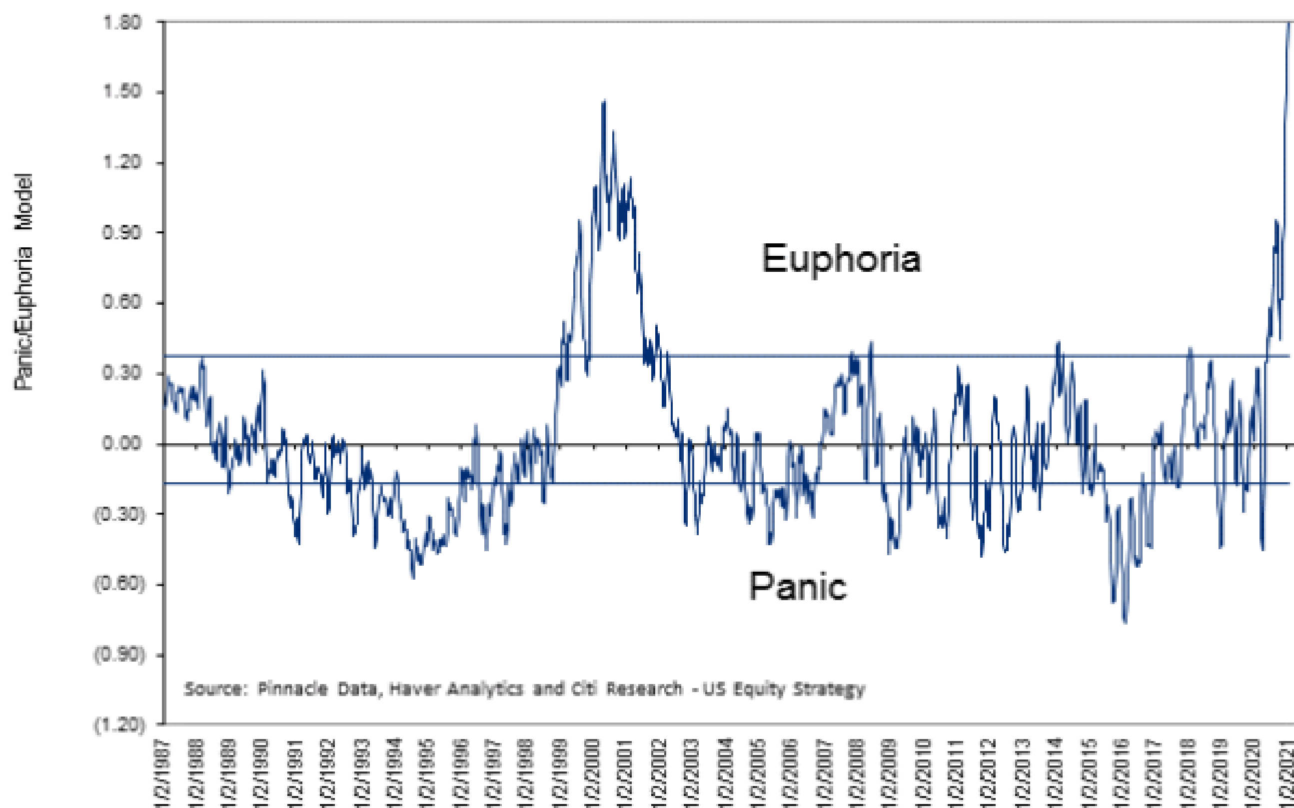
[1] Value and Growth performance using Russell 1000 Value and Russell 1000 Growth, per Morningstar
[2] Sector performance courtesy of JPMorgan's Guide to the Market, 4Q20.
[3] International stock performance from MSCI via Morningstar
[4] Bond performance from BBgBarc averages via Morningstar

In the wild year that was 2020, it should probably also be noted that gold rose 20.9% (fn-5). Its return was negative in the fourth quarter, however, as the world began to look beyond the current crisis.

Activity

The vaccine news in late October sparked a surge into stocks, especially those more sensitive to the economy, on the belief that they would be the biggest beneficiaries when the pandemic ended. We also built up our international stock weighting by adding to both emerging and developing markets, which we had sharply reduced in the Spring. The other exchanges we made had the purpose of replacing defensive-tilting funds with those in the same category that were more opportunistic, because never in my career I've have I seen aggressiveness rewarded like it was in the second half of 2020. In addition, I've never seen such a performance difference between established and unproven stocks – not even in 1999. I don't know how long the window will be open to maximize risk, especially since it usually closes with no warning, but it is certainly open now.

Figure 1: Growing Euphoria



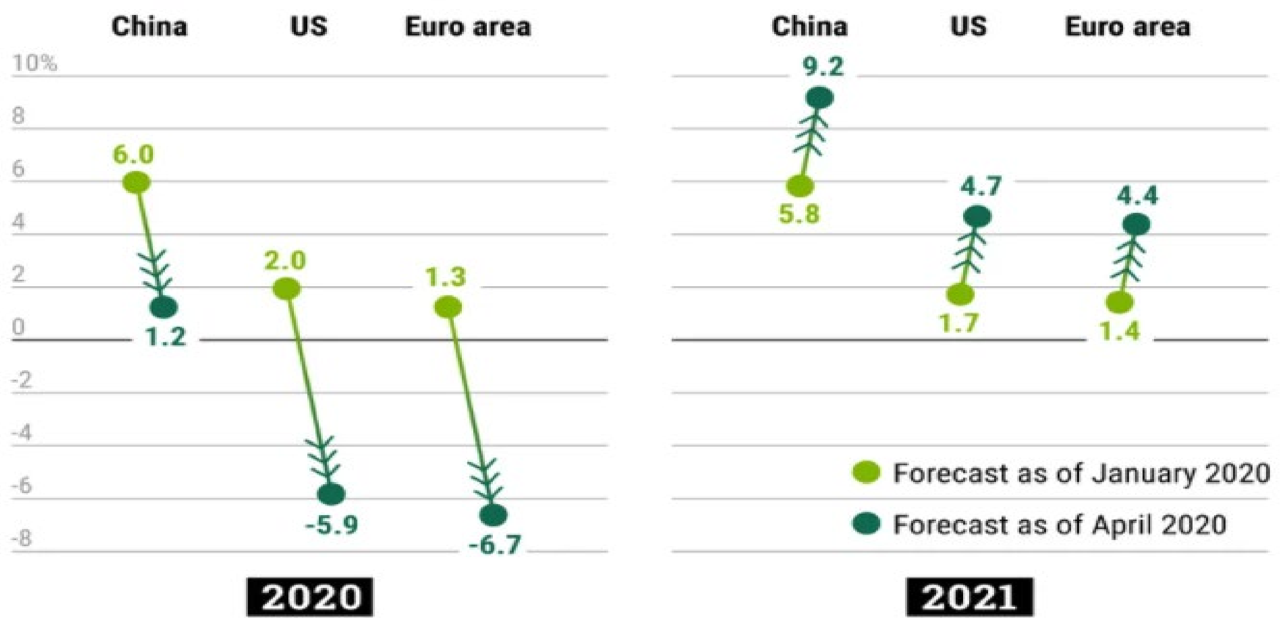
Source: Peter Boockvar

[5] Gold return taken from the DJ Commodity Gold Index again via Morningstar

Outlook

First, given the divided political environment, I'd like to highlight the fact that we reminded our clients three months ago that the markets do not care about anyone's politics. Markets react to the outlook for future after-tax, inflation-adjusted corporate profits. Period. In the short run, the focus is going to be on COVID. More specifically, did the market get ahead of itself in forecasting recovery or is it right to be looking beyond the pandemic? I tend to lean toward the former, because the U.S. is behind where we thought it would be in terms of vaccinations at the same time that the virus is apparently becoming more contagious. The narrative driving stock prices today is the expected pent-up demand post crisis. While it is true that the stock market has not fully priced in economic recovery, it would still be in for an unpleasant short-term shock if we have to go back to a more severe quarantining environment. The largest stocks in the S&P 500 have reached an average of 33 times forecasted 2021 earnings, which is in the top 1% of historic valuations. Only time will tell if today's investors were prescient or idiotic. All I know is that it is really difficult to deploy capital for risk averse investors at today's record high stock prices. For more aggressive investors, I believe you have to take the risk and hope the current investment environment continues.

Figure 2: COVID Effect on Major Economies



Source: GZERO Media

Commentary – The Evolution of Investing

The most significant development in 2020 was the rapid acceptance and adoption of new technologies. The COVID crisis necessitated doing things from home, which dramatically compressed the time it would have taken companies like Zoom and DoorDash to become such a part of our daily lives. In addition, it shortened the time it took concepts like gene editing and messenger RNA to become mainstream in medicine. The resulting astronomical price gains in firms harnessing these technologies has led to a complete re-think in the investment community in terms of how we use terms like "growth" and "value". Nowhere will one find a better discussion of the evolution of the concept of value than Howard Marks' brilliant piece, Something of Value (fn-6). In it he argues against the simplicity of the traditional price-to-earnings or price-to-book-value approaches to value investing. I will borrow from his essay liberally in discussing how I believe the stock market has evolved.

At the start of the previous century, it was commonly believed that bonds and preferred stocks were for investing and common stocks were for speculating. The former paid dividends and had precedence in the event of a bankruptcy, while the latter offered much greater returns if the enterprise thrived. During the first half of the 20th century, unfortunately, very few companies consistently did that. Of the original 30 companies Charles Dow used to formulate the Dow Jones Industrial Average in 1896, only one (General Electric) remained an ongoing concern 100 years later – and now even GE has been kicked out. In such an environment, Marks points out, the conservative "bird in the hand" type approaches tend to be favored. The investors who became famous, most notably Benjamin Graham and Warren Buffett, were able to use a company's financial statements to determine with a high degree of precision its present value. In possession of that information, all one needed was the patience to wait for the company to trade a discount. Given the manic-depressive nature of investors, "Mr. Market" routinely offered opportunities.

In the late 1960s, however, in response to technology (chiefly the transistor and the integrated circuit) offering improvements in communication and information processing, growth investing was born. This discipline involved projecting how valuable a company implementing a new technology might become. Marks stresses that this is inherently a more optimistic approach than value investing, but also subject to being wildly wrong (in both directions). The first growth bull market came to a crashing halt in the early 1970s as the oil crisis and inflation pummeled the economy; many of those firms saw their orders dry up as the recession hit. Growth investing got a second life in the 1980s with the advent of the personal computer, but it didn't really explode until the commercialization of internet technology in the mid-1990s. That was the biggest growth investing wave until the present one.

[6] Published in Seeking Alpha, January 11, 2011

The importance of this lesson is not that each growth wave eventually met its end, but that each successive wave advanced growth as a discipline. Growth investors realized that for companies to have a chance at long term success, they needed access to cheap capital and an investor base that would be willing to tolerate losses (sometimes huge losses) as the business "ramped up". That is the defining characteristic of the growth bull market of the 2010s and most especially of the market since the 2020 COVID plunge. Save for the electric vehicle credit, for example, Tesla actually lost money on each car produced until very recently. Investors have been willing to focus on the future, so losses have been no obstacle for either the stock price or the company's ability to raise more money by issuing stock. Revenue growth and market penetration have taken precedence.

One of the biggest takeaways from Marks' letter is that there are so many more people in the investment industry right now relative to last century and more importantly, that they have access to almost infinitely more powerful technology for crunching numbers. It is extremely difficult, therefore, to generate any advantage from understanding a given company's financial statements better than anyone else. This bull market has been led by those whose visions of what these new companies could become was boldest. All of this being said, it is a completely open question as to how investors would respond to a sharp correction that targeted these new, disruptive companies (note that the COVID sell-off almost from day one punished older, more established company stocks worse). Would investors hold their ground if Roku and Airbnb stock fell by half while PepsiCo and Caterpillar were going up (fn-7) I have never found investors to be capable of holding their convictions for any length of time during which they were losing money while others were gaining.

Marks' article points out that despite Ben Graham's reputation for buying companies at less than intrinsic value, his biggest winner in his lifetime was GEICO, a growth company. Warren Buffett has also benefitted mightily from growth stocks such as Coca-Cola and now Apple. Success today seems to require intellectual flexibility, or the ability to adapt to what the market was offering you at a given time. We are rigidly non-dogmatic here at Capital Strategies. Like everyone else we can determine what is working in the investment world, but we strive to understand why it is working and under what circumstances might it stop working. Today we have a bull market fueled by low interest rates and an implied promise from Federal Reserve Chairman Jerome Powell that he will continue to provide ample liquidity to markets. The global economy will almost certainly be much stronger in 2021 than it was in 2020. These factors seem to warrant paying a higher price for stocks than at any point in the past, and certainly more than I ever would have guessed I would be willing to pay when I started in this business more than thirty years ago.

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[7] Essentially, it was sector rotation that killed off the previous growth bull markets more so than outright recession.

A super-accommodative Fed doesn't ensure that stocks won't decline, but it does suggest that unless investors completely lose their heads that any decline is likely to be muted. We should continue to be in an environment in which new companies with innovative products can thrive.

Eric C. Graber, President
952-926-3000

Mark A. Carlton, CFA, Trademark Financial Management
Consultant to Capital Strategies Financial Corporation
952-358-3395