Evoke | ARIS Insights: Investment Lessons from 2020

January 2021

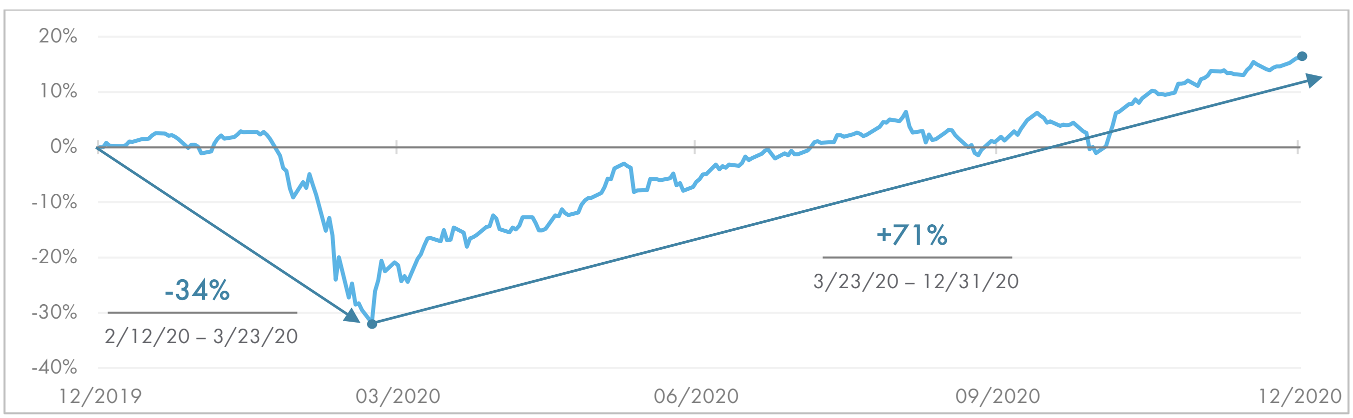
We have officially turned the calendar and 2020 is finally in the rearview mirror. Highlights include a global pandemic unimaginable a year ago, zero (or negative) interest rates across most of the world, multi-trillion-dollar fiscal deficits in the U.S. and the greatest degree of political polarization since the 1930s. Other than causing gray hair, the 2020 experience offered many valuable investment lessons. We would like to summarize two of the most important in this edition of *Insights*.

Lesson #1: Markets are Unpredictable

Upon the sudden realization that a global pandemic was underway, the global stock market plummeted 34% over a 5-week period.[1] This was the fastest decline of this magnitude in recorded history. While there was clearly a sense of panic, the degree and speed of the drop was understandable considering that an overwhelming percentage of businesses essentially shut down overnight. An economic outcome this extreme was certainly not discounted up to that point and not contemplated by the vast majority of market participants. At the market lows near the end of March, the outlook was dire with little sense of how we could come out the other side intact. This completely unpredictable experience should rank among the most remarkable in our lifetimes and serves as another reminder of how difficult it can be to time markets.

The market madness of 2020 didn't end there. Despite seemingly parabolic surges in global COVID-19 cases and ongoing economic strains, the stock market fashioned a complete reversal, with several indices reaching new all-time highs. The diametrically opposed outcomes between the stock market and underlying economic fundamentals has baffled a large number of professional investors and pundits. For those who sold in February or March, the breathtaking market recovery may have been an even more stressful experience than the downturn.

Exhibit 1. Global Stocks Suffer Historically Rapid Decline, Followed by A Raging Bull Market[2]



An interesting dynamic within equities also amazed investors in 2020. Prior to the downturn, many argued that the market was becoming top heavy led by a few technology companies with promising stories materially outperforming the rest and achieving stratospheric market capitalizations. The narrative was reminiscent of the late 1990s just prior to the historic tech crash when many of the tech darlings during the boom subsequently went out of business.

[1] Source: Bloomberg. MSCI World Index (BB: NDDUWI) returned -33.97% from 2/19/20 – 3/23/20.
[2] Source: Bloomberg. Return of global stocks based on MSCI World Index (BB: NDDUWI).

Similar to 2000, we entered a substantial bear market in the first quarter of 2020, but this time rather than leading the decline the tech stocks surged, further distancing themselves from the competition. Forcing people to stay home increased the demand and spending in technology at the expense of the old economy, which suffered an astonishing hit. In fact, the pandemic likely accelerated the ascendancy of the digital age. The extraordinary market impact can be condensed with a few astounding statistics:

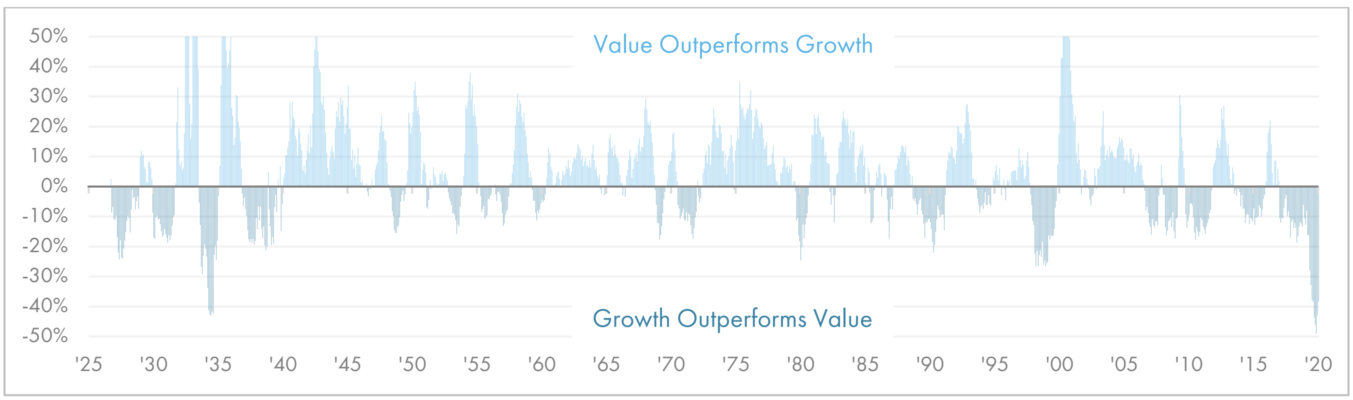
1. The 6 biggest companies in the U.S. (Amazon, Apple, Facebook, Alphabet, Netflix and Tesla) represent 23% of the S&P 500 Index, the heaviest weighting in 40 years.[3]

2. At one point, Apple's market capitalization of over $2 trillion surpassed the entire Russell 2000 Small Cap Index, which includes over 2,000 public companies.[4]

3. Tesla surged 743% last year during a pandemic when global automobile sales dropped 17% from the prior year.[5] The current Tesla valuation now exceeds the next 9 largest automobile companies combined.[6]

4. Growth stocks (which tend to overweight technology) outperformed value stocks (which emphasize old economy companies) by 35% in 2020. This far exceeded the difference we saw leading up to the tech bubble in the late 1990s and over the course of the year reached the largest spread we have seen in 90+ years of market history.[7]

Exhibit 2. Rolling 1-Year Value Trails Growth by Largest Margin in 90+ Years[7]



As an indication of the challenges of predicting market behavior, this unique outcome caught some of the smartest investors off guard. Many of the most sophisticated quantitative investment managers in the world, who utilize decades of data and vast computing power to develop their strategies, suffered significant losses as long-term market relationships broke down.

[3] Investopedia.com, *Top 10 S&P Stocks by Index Weight.* Gabe Alpert, 01/09/2020. https://www.investopedia.com/top-10-s-and-p-500-stocks-by-index-weight-4843111. AdvisorPerspectives.com, *Is the Market Top-Heavy?*, Larry Swedroe, 11/16/2020. https://www.advisorperspectives.com/articles/2020/11/16/is-the-market-top-heavy

[4] FinancialTimes.com, *Apple's Value Vaults Over Entire US Index of Small-Cap Stocks,* Robin Wigglesworth, 09/06/2020. https://www.ft.com/content/80dfa337-031f-4b67-aadb-1e03a697e0d6

[5] Statista.com, *Number of Cars Sold Worldwide Between 2010 & 2021, Worldwide; Scotiabank; Ward's; Bloomberg; 2010 through October 2020.* https://www.statista.com/statistics/200002/international-car-sales-since-1990.

[6] CNBC.com, *Tesla's Market Cap Tops The 9 Largest Automakers Combined – Experts Disagree About If That Can Last,* Michael Wayland & Laura Kolodny, 12/14/2020. https://www.cnbc.com/2020/12/14/tesla-valuation-more-than-nine-largest-carmakers-combined-why.html.

[7] Source: Dimensional Fund Advisors, Fama/French US Value Research Index and Fama/French US Growth Research Index, July 1926 – November 2020. Performance presented in Exhibit 2 represents the difference in rolling 1-Year returns between the two Fama/French indices.

For fixed income investors, 2020 presented yet another instance of interest rates falling when the universal expectation was for rates to finally start rising. Interestingly, rates have been trending down over the past 40 years and are lower now than they were during the Global Financial Crisis. Talk of a future with higher rates started in the mid-2000s when it first appeared that they couldn't possibly go any lower. Those who bet against high quality bonds or shortened their duration because of fear from rising interest rates have generally been on the wrong side of that trade for over a decade and were again surprised by a massive bond rally in 2020.

In the world of commodities, an unprecedented event occurred when the May WTI futures contract turned negative for the first time in history, reaching a record low of -$37 on April 20, 2020.[8] This unfathomable incident indicates a brief period during which investors were paid for taking oil as we faced a collapse in demand and very limited storage. This was far outside the range of imagined possibilities for market participants and likely missing from most sophisticated financial models.

The violent swings last year reminded us once again how challenging it can be to time markets. The recent experience highlights the importance of maintaining proper diversification and strong balance in portfolios. It is also another confirmation that the benefits of a disciplined process are more reliable than attempting to time markets. Importantly, with good balance there is less need to react to drastically shifting market environments. We all appreciate that investors are supposed to buy low, but frightening events such as those we all lived through last year often lead to impulsive decisions to *sell* low to a material detriment over the long run. Holding a balanced allocation before random "black swan" events can instill greater confidence to hold on through the trough. It is easier to maintain conviction when your portfolio has performed defensively while markets are crashing around it.

Lesson #2: The Fed Will Do Whatever It Takes

Last year, we also gained precious insight into the perspective of key policy makers that should inform our investment decisions looking ahead. The Federal Reserve revealed its full arsenal and its intent to do whatever it takes to save the economy at the depths of the collapse in early 2020. They took swift and forceful action by cutting interest rates to zero and announcing an "unlimited" quantitative easing program, which ultimately financed over $3 trillion of fiscal stimulus.[9] They followed these actions by backstopping various credit markets including some high yield bonds. This was a clear signal that they stand willing and able to do everything within their power to come to the rescue.

Later in August, they communicated a major shift in how they plan to set interest rate policy going forward. Over the past 40 years the Fed's goal has been to head off inflation by pre-emptively raising rates at the first hint of rising inflation expectations. Now that the greater concern is the risk of deflation, the new approach is to keep rates low for an extended period until actual inflation forces their hand.[10] This marked a major inflection point in their longstanding mindset that has prevailed since the inflationary 1980s.

The sheer speed and magnitude of the pandemic-led economic decline also accelerated the introduction of Modern Monetary Theory (MMT) from theory into practice. MMT refers to the next stage of monetary policy. The Fed's normal tool for stabilizing the economy is to control short-term interest rates. With rates stuck at zero, that traditional tool has been exhausted. The next approach is to print money and buy assets, which helps to lower long term interest rates and

[8] Source: Bloomberg, WTI Futures (BB: CL1), -$37.63 as of 4/20/2020.

[9] CNBC.com, *Federal Reserve cuts rates to zero and launches massive $700 billion quantitative easing program*, Steve Liesman, 03/15/2020. https://www.cnbc.com/2020/03/15/federal-reserve-cuts-rates-to-zero-and-launches-massive-700-billion-quantitative-easing-program.html

[10] CNBC.com, *Powell Announces New Fed Approach to Inflation That Could Keep Rates Lower for Longer*, Jeff Cox, 08/27/2000. https://www.cnbc.com/2020/08/27/powell-announces-new-fed-approach-to-inflation-that-could-keep-rates-lower-for-longer.html

boost asset prices. This tool, termed quantitative easing (QE), also has limited effectiveness as long-term interest rates near zero. The third policy tool is MMT, which involves a coordinated response between monetary and fiscal policy. In other words, the Fed prints the money that Congress spends. The pronounced plan is for the Fed to print trillions of dollars and give it to the government to inject directly into the economy with fiscal spending packages. During the crisis, Congressional approval on how to distribute the funds was enacted relatively quickly, however there is a question about the efficiency of the coordination during non-emergency environments.

These major changes in the Fed's stance and associated policy moves demonstrate a clear shift that can have major investment implications for the foreseeable future. U.S. borrowing rates may stay low for a long time. The odds of an economic or market collapse are probably lower given the Fed's cited emphasis and demonstrated ability to prevent such an outcome. Historically, recessions had typically been preceded by Fed tightening to fight inflation. The next recession, like the one we just suffered, will probably be caused by some other catalyst.

The final repercussion from these shifts in policy is a growing risk of inflation. The Fed has promised to utilize every instrument in its toolkit (including innovative solutions like MMT never used before in the U.S.) to prevent deflation and economic stagnation and to err on the side of higher inflation. However, this can be a dangerous game as inflation can quickly get out of hand and make the Fed's job much more difficult. It's easy to print money to stimulate growth when inflation is a distant concern, but if pressures increase then the trade-offs between growth and inflation can introduce significantly greater uncertainty about future Fed decisions. Market volatility and downside risks could increase in this type of environment.

As a result, we urge clients to consider owning more inflation hedges. It is also important to think about the different types of inflation that may ultimately unfold in the years ahead. The print and spend policies have limits if a tipping point is reached and there is a loss of faith in paper money. Thus, we believe a diversified mix of inflation-hedged assets such as gold, commodities, inflation-linked bonds and perhaps real estate may be appropriate as a critical part of a well-balanced portfolio.

The markets ultimately survived the scare in 2020 and posted surprisingly attractive returns for the year. That said, it would be imprudent to overlook the important lessons offered in the process. These valuable insights will help us as we continue to improve portfolio composition to be resilient in the next market surprise.

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