Strategic Asset Allocation Committee

Spring 2021

Summary

The 56% return for the S&P 500® Index over the past two years is the strongest since 1997-1998, while the 89% gain for the Russell 1000 Growth® Index is the highest 2-year period on record since its inception in 1979 (see chart below). The returns that the stock market displayed in 2020 were nothing short of remarkable, especially on the heels of even higher returns in 2019, which many of us may not remember. However, it was a crazy ride, and as of March 23 of last year, the entire 2019 gain had been lost in just 4 weeks as the fears of a global pandemic gripped the market. The dramatic moves of 2020 may have made many of us forget just how good the market had been prior to the outbreak of COVID-19, but now that we seem to be reaching the later stages of the global pandemic, investor concerns seem reminiscent of the end of 2019. Those include elevated stock valuations, potential for higher interest rates, elevated government debt levels, and a strained relationship with our largest economic rival, China. The bulls would say we are in a new industrial revolution based on technological advances and innovation while the bears would say stock prices have become unhinged from company fundamentals and that government intervention has artificially inflated economic growth and asset prices. We tend to consider ourselves somewhere in between and think that relatively high valuations and an impressive decade of above-average stock returns (S&P 500 has returned 14%) is likely to result in less exciting, albeit positive, returns as we go forward. However, the combination of low interest rates, additional economic stimulus, and widespread distribution of the COVID vaccine resulting in a more broad re-opening of the US economy could drive solid market returns over the next year. Additionally, a continued rotation from some of the beloved "stay at home" stocks to some underloved areas of the market may help improve portfolio returns over the next several years.

Category[1]	2019	2020	2-Year Return[2]	Best 2-Year Since:
Large Cap	31.5%	18.4%	56%	1997-1998
Mid Cap	30.%	17.1%	53%	2012-2013
Small Cap	25.5%	20.0%	51%	2012-2013
Developed International	22.0%	7.8%	32%	2009-2010
Emerging Markets	18.4%	18.3%	40%	2009-2010
Intermediate Bonds	6.8%	6.4%	14%	2002-2003
Value Stocks	26.5%	2.8%	30%	2013-2014
Growth Stocks	36.4%	38.5%	89%	Highest Ever (1979-present)
Nasdaq 100	39.5%	48.9%	108%	Highest Ever (2000-present)

Source: Morningstar Direct

[1]U.S. Large Caps represented by the S&P 500 Index. U.S. Mid Caps represented by the Russell Midcap Index. U.S. Small Caps represented by the Russell 2000 Index. U.S. Growth Stocks represented by the Russell 1000 Growth Index. U.S. Value Stocks represented by the Russell 1000 Value Index. International Stocks represented by the MSCI EAFE Index. Emerging Market Stocks represented by the MSCI EM Index. Int'l Small Stocks represented by the MSCI ACWI ex USA Small Index. Intermediate Term Bonds represented by the Bloomberg Barclays Intermediate Government/Credit Index. Value Stocks represented by Russell 1000® Value Index. Growth Stocks represented by Russell 1000® Growth Index. Nasdaq 100 represented by NASDAQ 100 Index.
[2]Data as of 1/1/19- 12/31/20.

Strategic Asset Allocation Recommendations Spring 2021		
Prefer	vs.	Oppose
Stocks	vs.	Bonds
Small	vs.	Large
Value	vs.	Growth
Emerging	vs.	Developed Int'l
Corporate Credit	vs.	Treasuries
Commodities	vs.	REITs

Source: Morningstar Direct

In our previous report, we recommended being overweight to stocks versus bonds and highlighted small cap stocks, emerging markets, high yield bonds, and gold as attractive investment opportunities. Since then, the stock market has seen tremendous gains and there was a shift in investor preferences toward some of the more cyclical areas that we were recommending. Our expectation for an improving economy is the basis for our views, therefore, we continue to prefer stocks given further economic stimulus and low yields on most fixed income investments and think small stocks and emerging markets could do well over the longer term. High yield bonds have become less attractive as their prices have risen dramatically along with the stock market, resulting in a sharp decrease in yield. Gold remains a viable option for those worried about the possibility of weaker currencies and higher inflation resulting from the massive economic stimulus around the globe. However, a broader commodity position (that includes exposure to precious metals, energy, and agricultural commodities) might be a better position if the economy continues to rebound and inflation rises.

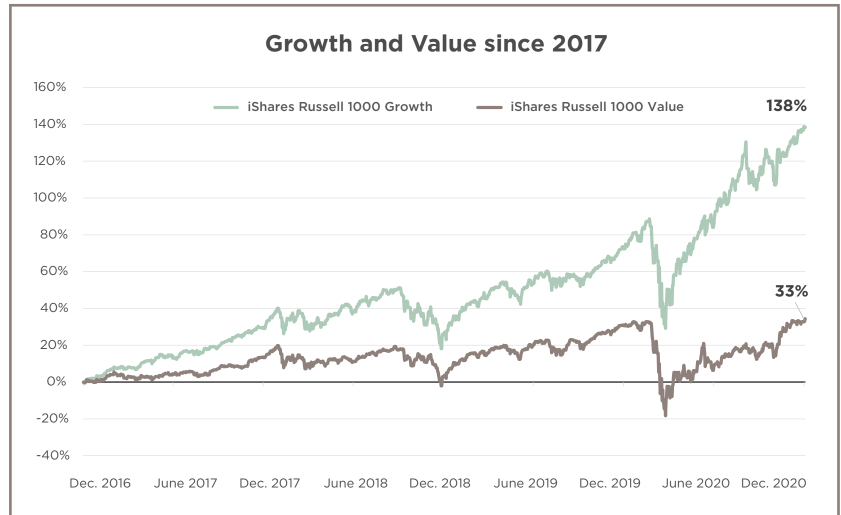
Some of Our Thoughts for 2021:

1. If you can handle the risks, own more stock

- We're in a unique position where both stocks and bonds look expensive, but stocks have the potential for growth while bond returns are primarily dependent on income.
- Expectations for mid-single digit GDP growth and an improving economy should drive both stock prices and interest rates higher (meaning bond prices could decline).
- We view bonds as important for capital preservation in conservative portfolios, but unlikely to generate meaningful returns as they have in the past.
- We think stocks should beat bonds over most multi-year time periods, but will likely be volatile given relatively high valuations and fast-moving markets.
- We expect returns over the next decade to be more moderate than the 10-11% historical annual average with more dramatic market moves from one year to the next.
- The large run of 2019-2020 has resulted in most accounts being over-weighted to stocks.
    - More aggressive investors looking for capital appreciation should remain overweight to equities.
    - Conservative investors and those with near term needs for cash may consider rebalancing back to target allocations or holding more cash.

2. Rotation toward "value" may continue in near term but evolution of economy may favor "growth" stocks longer term

- Growth has dominated value since 2017 with a dramatic acceleration in 2019 and 2020 – see chart at right.
- Value rotation seen in Q4 and early 2021 could continue as a further re-opening of the economy drives better results for travel, industrials, materials, and energy stocks.
- Valuations seem to be reaching an extreme within some "growth" sectors and could make gains more difficult in the near term but a changing global economy could favor "growth" over longer term.



Source: Morningstar Direct

- Dividend stocks could do well as yield-starved investors seek sources of income.

3. Emerging Markets re-emerging

- More innovation, higher economic growth rates, younger populations, and growth of the middle class may drive stronger returns in emerging markets than in developed markets like Europe and Japan.
- China is set to grow at a pace above its pre-COVID level, which will help those dependent on it, including Korea, Taiwan, Singapore, etc.
- New administration likely to be less combative with foreign entities than previous administration.
- Active Growth in developed markets: Developed international markets have an inherent value bias with heavy banking and industrial weightings. Therefore, actively managed, more growth oriented managers in both developed markets and emerging markets should likely perform better than the broad international market.

4. **Small Cap stocks recovered in late 2020 but could continue to outperform**

- Improving economic conditions and low, albeit rising, interest rates should favor small cap stocks.
- Small company innovation likely to remain important to investors and to drive merger/acquisition activity.
- Small cap stocks typically perform well in early stages of recovery; historically much of small cap outperformance comes in the early years of a bull market so could be setting up well (the chart below shows the 3-year returns after the last 5 recessionary bear markets).

Time Period	% Returns Russell 2000®	% Returns S&P 500 Index®
January 1979 - December 1981	102.31%	49.42%
August 1982 - July 1985	105.92%	104.62%
October 1990 - September 1993	110.54%	64.60%
October 2001 - September 2005	91.23%	59.01%
March 2009 - February 2011	117.39%	88.30%

Source: Morningstar Direct

5. **Diversifying assets for potential inflation**

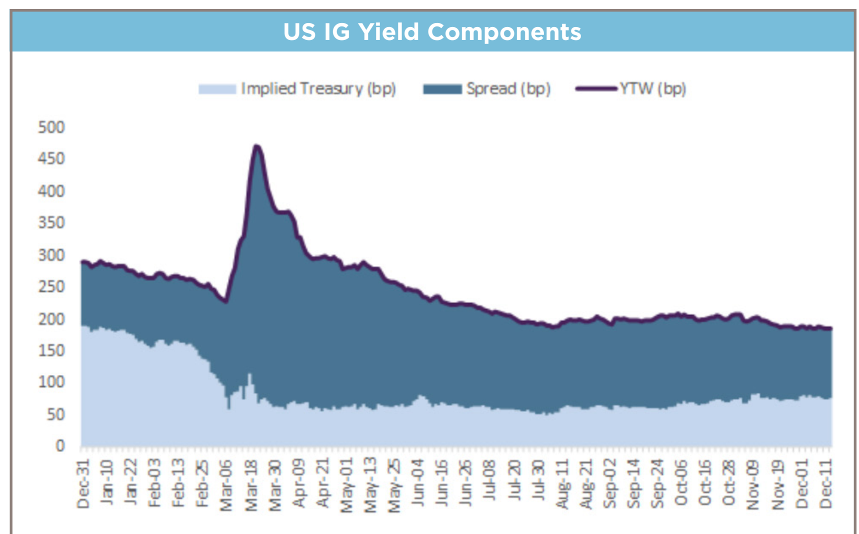
- Gold and other commodities can be a good way to diversify ones’ portfolio, particularly during times of higher inflation.
- While inflation may not spike in the near term, it could rise as government stimulus seems likely to continue for some time.
- In our last report, we suggested gold as it often does well for several years after economic downturns as investors continue to fight the last battle by buying lower volatility assets. We still think that is a possibility but the compression of last year’s recovery (70% gain from March 23-Dec. 31) may reduce the likelihood.
- A broader commodity play could do better in an environment of improving global economic activity. Broad commodity investments can include precious metals, agriculture and energy investments.

Average Yearly Return			
Inflation Level	Gold	Commodities	Oil
>3%	12.9%	19.4%	27.7%
2% to 3%	5.2%	8.7%	12.8%
<2%	1.8%	-23.9%	-24.8%

Source: Morningstar Direct; 1990 to present; S&P GSCI Gold Spot, S&P GSCI TR, and S&P GSCI Crude Oil Indexes.

6. **Remain in short-term bonds for capital preservation piece of a portfolio**

- Bonds for safety, not returns: bonds are unlikely to provide much return but should still hold up well in the event of a market downturn.
- Stay short-term: rates could increase as the result of more fiscal stimulus leading to increased Treasury issuance; short-term bonds are less sensitive to movements in interest rates.
- Underweight treasuries: treasury bonds are the most sensitive to the potential for higher interest rates, which means they are most likely to lose value when rates rise.
- Overweight quality corporates: corporate bond spreads have compressed significantly since our last report, but still provide some yield cushion in the event of rising interest rates and can continue to do well in a benign economic environment supported by fiscal and monetary stimulus.
    - Despite a lot of fluctuation throughout the year, the chart below shows that, credit spreads, the compensation you receive on a corporate bond above risk free Treasury rates, were lower in December than they were in January.
    - Spreads saw almost 4x increase from a low of 100 basis points (bps) (or 1%) early in the year to almost 400bps (or 4%) at the peak of the Covid-19 driven sell-off.
    - The chart on the right illustrates 2020's path to lower yields - light blue section reflects Treasury rates, which fell dramatically early in the year due to Fed monetary policy, coupled with additional liquidity support; dark blue section reflects the credit spread component, which widens as perceived credit risk increases, resulting in lower prices and vice versa.



Source: CreditSights, ICE BofAML Indices

    - High yield bonds less attractive: yield spreads for high yield bonds have declined from about 700 bps (or 7%) last summer to about 400 bps (or 4%) now, which is well below the longer term averages and below where they were before the pandemic.
    - Use bond funds, not indexes: We believe there will likely be further corporate defaults so an index strategy, that has a higher weighting to companies with more debt, could be more risky. Good active management has proven to add value in bonds.

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Investors' risk in emerging market economies can include political instability, domestic infrastructure programs, currency volatility, and illiquid equity.

Index Definitions:
The **S&P 500 Index** is comprised of 500 U.S. stocks and is an indicator of the performance of the overall U.S. stock market. The **S&P GSCI Gold Index**, a sub-index of the S&P GSCI, provides investors with a reliable and publicly available benchmark tracking the COMEX gold future. The index is designed to be tradable, readily accessible to market participants, and cost efficient to implement. Standard & Poor's Financial Services LLC, a division of S&P Global, is the source and owner of the registered trademarks related to the S&P 500 Index. The **Russell 1000® Value Index** measures the performance of the Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values. The **Russell 1000® Growth Index** measures the performance of the Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values. The **Russell 2000® Index** measures the performance of the 2000 smallest companies in the Russell 3000® Index. The Russell Top 200® Index is a market capitalization weighted index of the largest 2000 companies in the Russell 3000®. London Stock Exchange Group PLC and its group undertakings (collectively, the "LSE Group"). © LSE Group 2020. FTSE Russell is a trading name of certain LSE Group companies. "Russell®" is a trade mark of the relevant LSE Group companies and is used by any other LSE Group company under license. All rights in the FTSE Russell indexes or data vest in relevant LSE Group company which owns the index or the data. Neither LSE Group nor its licensors accept any liability for any errors or omissions in the indexes or data and no party may rely on any indexes or data contained in this communication. No further distribution of data from LSE Group is permitted without the relevant LSE Group company's express written consent. The LSE Group does not promote/sponsor/endorse the content of this communication. The **ICE BofA US High Yield Index** tracks the performance of below investment grade, but not in default, US dollar-denominated corporate bonds publicly issued in the US domestic market, and includes issues with a credit rating of BBB or below, as rated by Moody's and S&P. The **iShares Russell 1000 Value ETF** seeks to track the investment results of an index composed of large- and mid-capitalization U.S. equities that exhibit value characteristics. The **iShares Russell 2000 Growth ETF** seeks to track the investment results of an index composed of small-capitalization U.S. equities that exhibit growth characteristics.

An index is not available for direct investment; therefore its performance does not reflect the expenses, fees and taxes generally paid with the active management of an actual portfolio.