Market Report
Fourth Quarter 2020

Key Points

- Value stocks finished strong, as the underlying tone of equity markets seemingly changed in the final two months of the year.
- Generally expensive technology related issues have an outsized weighting in the S&P 500 and Russell 3000 Growth.
- Economic moats come in different forms. We discuss cost advantages in this letter.
- Mortgage rates are hovering around all-time lows. Estate planning criteria may change.

Total Return as of December 31, 2020						
				Annualized		
	QTD	**YTD**	**1 Yr.**	**3 Yr.**	**5 Yr.**	**10 Yr.**
S&P 500	12.1%	18.3%	18.3%	14.1%	15.2%	13.9%
NASDAQ	15.6%	44.9%	44.9%	24.4%	22.2%	18.5%
Russell 3000						
Index	14.7%	20.9%	20.9%	14.5%	15.4%	13.8%
Value	17.2%	2.9%	2.9%	5.9%	9.7%	10.4%
Growth	12.4%	38.3%	38.3%	22.5%	20.7%	16.9%
Russell Mid Cap						
Index	19.9%	17.1%	17.1%	11.6%	13.4%	12.4%
Value	20.4%	5.0%	5.0%	5.4%	9.7%	10.5%
Growth	19.0%	35.6%	35.6%	20.5%	18.7%	15.1%
Russell 2000 (Small Cap)						
Index	31.4%	20.0%	20.0%	10.3%	13.3%	11.2%
Value	33.4%	4.6%	4.6%	3.7%	9.7%	8.7%
Growth	29.6%	34.6%	34.6%	16.2%	16.4%	13.5%

The Year in Review

Time is an aspect of life that cannot be manufactured – it is limited and precious. Therefore, we generally do not encourage wishing any one year to end quickly just so another can begin. We are making an exception for 2020, though, and are happy to view it through the rear-view mirror.

After leaving the gate strong, U.S. equity markets declined rapidly as economic activity ground to a halt and fixed-income markets became dislocated. COVID-19 was the culprit, spreading across the U.S. and the world like a windstorm-fueled wildfire across the prairie.

The Federal Reserve (the “Fed”), Treasury and Congress acted swiftly in March to support capital markets and Main Street – containing the damage. Their actions contributed to declining fixed-income yields, narrowing credit spreads and rising equity markets. We worked diligently to capitalize on outsized investment opportunities that briefly existed during the disruption.

In the latter part of the year, the prospects of a COVID-19 vaccine and continued accommodative monetary policy overpowered the daily grind of raucous politics, civil unrest, and an uneven economic recovery. During the final two months, the underlying tone of equity markets began to shift as **value-oriented stocks outperformed growth issues**, on average. Perhaps the **disparity in valuations** between growth (expensive) and value (less expensive) stocks finally became too great (something we have commented on in recent letters), prompting portfolio rotation by some market participants. Also note the **performance disparity** between the two camps (index data, page one). Disparity of this magnitude is unusual, likely unsustainable and bodes well for value type issues, in our view.

U.S. Equities

In our 3Q 2020 letter we devoted toner to the correlation between beginning valuations (think P/E ratios for simplicity) and long-term annualized investment results. With that in mind, we touch on economic sector weightings across the S&P 500, Russell 3000 Growth and Russell 3000 Value indices immediately below, followed by recent P/Es relative to 20-year averages.

Sector Weightings											
	Energy	**Materials**	**Financials**	**Industrials**	**Cons. Disc.**	**Tech.**	**Comm. Svc.**	**Real Estate**	**Health Care**	**Cons. Staples**	**Utilities**
S&P 500	2.3%	2.6%	10.4%	8.4%	12.7%	**27.6%**	10.8%	2.4%	13.5%	6.5%	2.8%
R3000G[1]	0.1%	0.8%	1.9%	4.5%	16.8%	**45.1%**	11.1%	1.6%	13.6%	4.6%	0.0%
R3000V[2]	4.4%	4.8%	19.6%	13.4%	7.7%	9.7%	9.6%	4.4%	13.4%	7.6%	5.5%

1. Russell 3000 Growth Index; 2. Russell 3000 Value Index; Source: 1Q 2021 Guide to Markets

As you will note in the table above, **technology** is the largest weighting in the S&P 500 (27.6%) and the Russell 3000 Growth (45.1%). Many of the largest, fastest growing, and most expensive companies fall into the technology sector. **Now**, let's look at year-end valuations (again, think P/Es for simplicity) relative to 20-year averages.

As reflected in the accompanying table, whether large, mid or small-caps, none are cheap relative to their 20-year average P/E. However, value-oriented companies, on average, are the least expensive with growth companies the most expensive.

Current P/E as % of 20-Year Average P/E			
	Value	**Blend**	**Growth**
Large	130.6%	144.8%	168.5%
Mid	127.1%	139.4%	194.6%
Small	107.2%	143.6%	198.5%

Source: Guide to Markets 1Q 2021

Given the technology weighting in many market cap weighted indexes like the S&P 500 and Russell 3000 Growth, coupled with the relationship between beginning of period valuations and long-term annualized returns, broad market indexes/strategies may face **greater headwinds** than a more concentrated, business-like approach over the next seven to 10 years. Most of our investment strategies that have an equity component hold **25-40 individual stocks**. This narrower focus allows us to be more selective than investors holding a greater number of stocks.

Financials posted strong returns during the quarter as the group generally maintained strong balance sheets, and the outlook for interest rates and loan charge-offs, two key drivers of banking profitability, improved.

Fixed Income & Commodities

It was another quiet quarter in fixed-income land. Corporate bonds' total returns, as measured by the ICE BofA U.S. Corporates 1-10 Yrs., increased 1.8% during the quarter. U.S. Treasuries and Agencies, as measured by a similar index, decreased 0.2%.

Credit spreads narrowed and yields declined across credit and maturity spectrums, again, in large part due to the Fed's continued support. Our fixed-income strategies, on average, are focused on the shorter end of the yield curve within the investment grade space. Convertible securities meeting our criteria remain limited.

This year was a record year for corporate bond issuance. Default rates generally declined going into the quarter, in part due to strong demand for higher yielding issues (weaker credits) which allowed struggling companies to refinance maturing debt. The ultra-low interest rate environment is promoting the misallocation of capital at an accelerating pace, in our view.

Commodities, as measured by the Bloomberg Commodity Index, increased 10.2% for the quarter, yet finished the year down 3.1%. Oil (WTI) rose 20.6% for the quarter to $48.52 but was still down 20.5% for the year. The prospects for supply and demand coming into balance seem to be improving. Increased economic activity should help.

Economic Moats

An economic moat is a competitive advantage that permits a company to earn a return on its capital **above** its cost of capital for long periods of time. Excess return on capital and revenue growth build long-term business value. Companies that exhibit such attributes are generally viewed as high-quality companies. All things equal, we prefer to own high-quality companies as we believe they will outperform over long time horizons.

Moats come in different forms, including, but not limited to: cost advantages, intangible assets, switching costs, network effect and scale. We will address cost advantages below.

A company has a cost advantage (i.e. is a low-cost producer) when it can profitably sell goods or services to customers at a lower price point than its competitors. In good times, a low-cost producer can sell its goods or services at or near the same price as less efficient competitors, and enjoy a higher profit margin and return on capital. In bad times, the low-cost producer can lower its prices and still earn a profit while competitors with high production costs struggle.

Moats can widen, stay the same or narrow over time. Ideally, we would prefer to only own companies that consistently widen their moat. This, however, is impractical for a host of reasons including, but not limited to when such a company's stock trades at a significant premium to its intrinsic value.

Mortgage Rates & Estate Planning

Mortgage rates have been hovering around all-time lows. As of this writing, 30-year fixed-rate mortgages are advertised with rates **less than 3.0%**. If you have a mortgage, evaluate whether refinancing is advantageous for you.

Estate planning is **necessary** to **efficiently** transfer wealth to future generations. Currently, individuals have an $11.7 million ($23.4 million for a married couple) combined federal estate and lifetime gift tax exemption equivalent for 2021. **However**, the base exemption amount declines to **$5 million** in **2026**, **absent a change sooner**. The incoming administration **may push to reduce the exemption equivalent before 2026**. Estates exceeding the exemption equivalent by $1 million hit the top estate tax rate of **40.0%**. Is your estate plan in order?

Looking Ahead

The rollout and acceptance of COVID-19 vaccines and a sizeable stimulus package early in the year are eagerly **anticipated** by market participants. This **enthusiasm** coupled with ultra-low yields and financing costs has contributed to the price of public and private companies being "**bid up,**" in our view, which likely has pulled some future broad-market returns into the current period.

Remember, it is only **after the tide goes out** that many investors will realize they took excessive risks. We believe our narrower focus and value-oriented investment process are especially well-suited for navigating the current, cheery environment whereby various risks are being discounted and speculation is running amok. Keeping a keen eye on intrinsic values, maintaining discipline and being mindful of changing governmental policies will be important as we progress through 2021.