February 17, 2021

# Where is Your Umbrella?

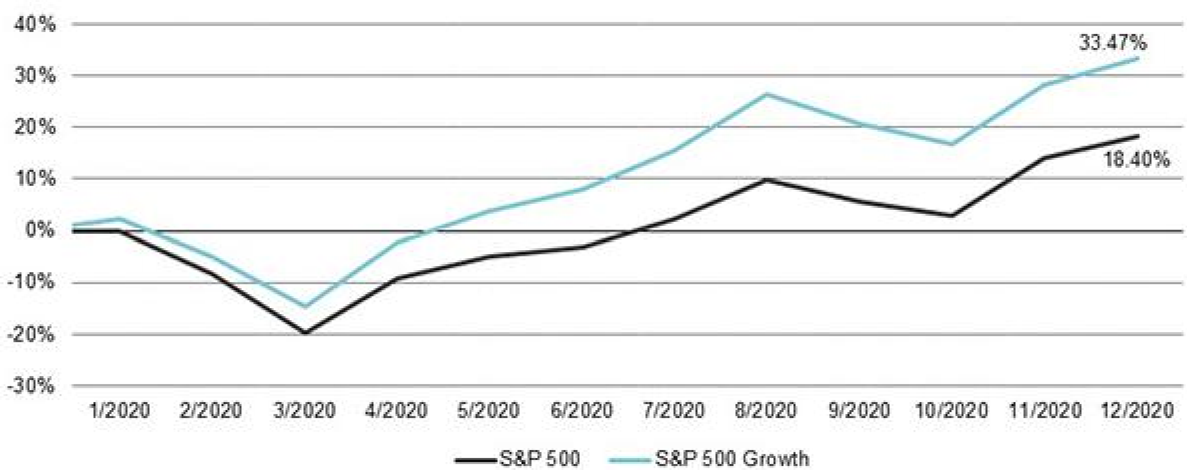
2020 was a highly unusual year, to say the least. What's in store for 2021 remains to be seen. After a brief sell-off during the early stages of the pandemic one year ago, equity markets quickly recovered despite the crippling effect of COVID-19 on the global economy. High-growth, high-momentum names have been by far the best performers. In this setting, investors should focus on stock valuations, as they may matter more for returns going forward.

When we dig deeper into recent market performance, we generally find two categories of stocks that have rallied particularly hard and thus may warrant investor caution. First, high-growth stocks disproportionately benefited from a fall in interest rates, as the lowering of the discount rates mattered more for perceived high-duration assets. The other notable category includes the various "story" stocks, which have been on a tear even though these companies' business models are as yet unproven. Such speculative investments simply do not meet our quality criteria.

## 1. High Growth Stocks Rally

Figure 1 shows that for 2020, the S&P 500® Index advanced 18.40%, while the growth component of the broad benchmark was up 33.47%. It was not a phenomenon confined to the U.S. – growth stocks led the MSCI All Country World (ACWI) Index by a similar margin. Also, for the year, momentum was one of the most powerful factors and there was a significant overlap between growth stocks and momentum stocks.

**FIGURE 1: S&P 500 INDEX VS. S&P 500 GROWTH INDEX**
Monthly returns 1/1/20-12/31/20




Source: FactSet, as of 12/31/20.

## What caused this massive divergence in performance between growth stocks and the rest of the market?

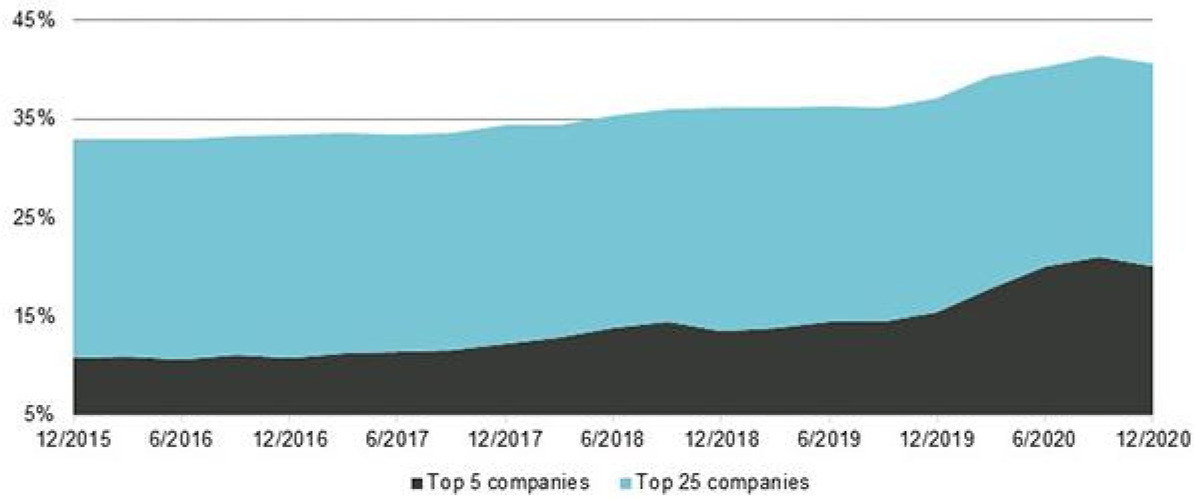
**Lowering of interest rates that began at the onset of the COVID pandemic** was a key factor. It was followed by central bank guidance that rates would remain low for an extended period of time, which in turn led to the market factoring in meaningfully lower discount rates. This benefited equities in general, but valuations of growth stocks in particular, as they are seen as longer-duration assets.

While the market's reaction was not irrational, we think it is important to consider a portfolio's aggregate exposure to this group of stocks. Although it is difficult to predict when rates may rise again, loose fiscal policy could produce inflationary pressures, necessitating rate increases sooner than consensus expectations. In that scenario, growth stocks would suffer a reversal of fortune, as they are more vulnerable to rising interest rates.

**Trends accelerated by the pandemic** also contributed to the outperformance of some growth stocks. Many of these stocks are technology companies that benefited from an increase in e-commerce and a shift to cloud computing. The market rewarded those stocks, which again was rational directionally. However, the magnitude of some of the stock moves may prove excessive. Investors should be careful not to extrapolate the acceleration of trends too far as some of the COVID-related changes may reverse in the short term when the pandemic fades.

**The narrowing of the market** is another related development. A limited number of tech names drove much of U.S. equity gains in 2020. Indeed, the combined weight of the top constituents rose significantly as a percent of the S&P 500 Index's total market capitalization (Figure 2). A similar phenomenon has been seen in other markets.

**FIGURE 2: S&P 500 INDEX: WEIGHT CHANGE OF TOP CONSTITUENTS**
5 Years ending 12/31/20 (Quarterly)




Source: FactSet, as of 12/31/20.

Many growth stocks that massively outperformed the market last year are good companies with attractive business models and growth prospects. But if the goal of a portfolio of quality growth stocks is to accumulate wealth with lower volatility and greater downside protection than the benchmark, then high growth, even if it is in quality businesses, cannot be bought at any price. A lack of valuation sensitivity may expose investors to an external shock. We will never know precisely what will cause the next external shock or correction to "high growth at any price" stocks. But if COVID-19 has reminded the investing world of one lesson, it is that we should always be prepared for the unexpected.

## 2. "Story" Stocks: Separating Facts from Fiction

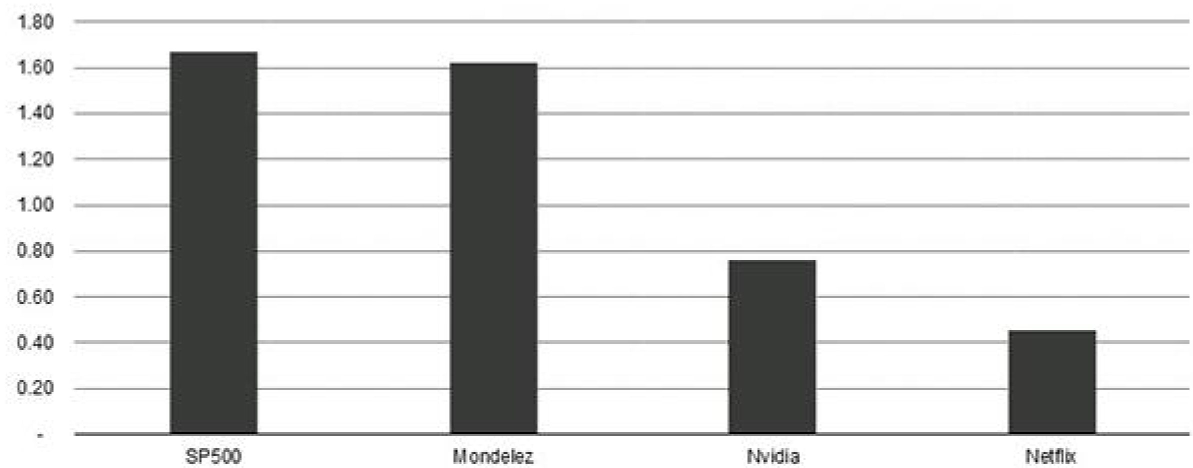
In addition to valuation risk, we are concerned by how trustful the market has been of some investment story stocks. For example, there has been a recent surge in special purpose acquisition companies (SPACs) – also known as "blank check" companies. These are funds that raise cash in the stock market with the promise of investing in a private company to take it public. In contrast to traditional IPOs, companies that become public through a SPAC are, in our view, under less regulatory scrutiny and have fewer restrictions on making rosy projections.

Another area of great story stocks today are the green technology companies that are attracting many eager investors. While the movement of the world and companies towards greater environmental sustainability might make sense and be necessary, we often find that when large amounts of capital chase a small number of opportunities, returns ultimately fall.

Sometimes stocks demonstrating positive momentum and low volatility can be akin to a “wolf in sheep’s clothing.” Investors should watch out in particular for low volatility stocks with increasing instability in company fundamentals, a large percentage of ownership by short-term investors like hedge funds, and all-around fast growth combined with rapidly increasing capital spending. These signs often foretell coming investment disaster.

This makes intuitive sense considering how hard it is to maintain supernormal growth over a very long period of time. It is interesting to note that the market volatility of some high-flying stocks like Netflix and Nvidia is below their earnings’ volatility. This sign of disconnect makes us wonder, is the market underestimating their fundamental risks?

**FIGURE 3: RATIO OF STOCK PRICE VOLATILITY TO EARNINGS VOLATILITY**
5 Years Ending 12/31/2019




Source: FactSet as of 12/31/19.

## The Power of a Balanced Quality Growth Portfolio

We do not know when or why the market may turn. Thus, we believe investors should favor a balanced approach to constructing high quality portfolios. Last year, investors with greater exposure to faster-growth stocks would have enjoyed better performance, largely courtesy of lower rates. But much like the British, who are used to unpredictable weather, we believe that always carrying an umbrella when leaving home, while inconvenient when the sun is shining, is still a sensible approach.

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