When Average is Anything But

"There are three kinds of lies – lies, damned lies, and statistics."
– Mark Twain (Chapters from My Autobiography - 1907)

Nothing will put most people to sleep faster than quoting statistics so to the extent that you have chronic insomnia…read twice and call us in the morning. Mark Twain's classic quote above is a humorous quip to suggest that numbers may not always be as they appear.

A similar thought could be applied to the often-cited S&P 500, Dow Jones and Nasdaq indices. ***What happens at the index level can often be quite different to that which happens under the surface.*** The most salient analogy might be that of a duck swimming on a pond. From above, it looks cool, calm, and collected – but below its churning like the dickens. Let's use the S&P 500 as an example. ***The table at right measures the maximum drawdown that occurred in each of the last three months.*** The drawdown is defined as the maximum peak to trough price decline for each time period. The max drawdown calculation is measured three different ways; taking the maximum drawdown of the index itself (S&P 500), the average maximum drawdown of the underlying stocks that make up the index ("Average" Stock) and the average maximum drawdown of the top five largest names in the index (Top 5).

"When Average is Anything But"

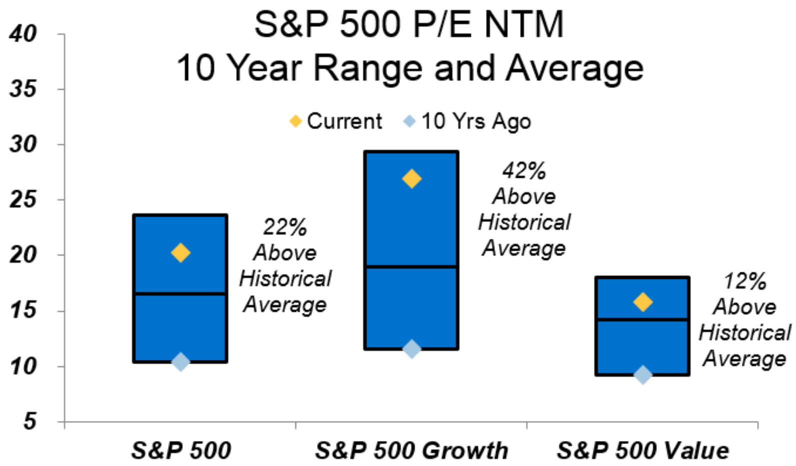
Max Drawdown Period	S&P 500	"Average" Stock	Top 5
September	-5.1%	-14.0%	-9.5%
August	-1.8%	-11.2%	-5.0%
July	-2.9%	-11.3%	-4.8%

Source: Factset, Constituents of the index are based on the holdings of the iShares S&P 500 ETF. The "Top 5" include AAPL, MSFT, GOOG, AMZN and FB - representing over 20% of the S&P 500 Index. Max Drawdown is measured as the max peak to trough price change over the time period stated for the S&P 500 Index, the average of the underlying constituents and the average of the top 5 largest companies by market cap.

A few observations stand out. First, market volatility ramped up in September with more severe drawdowns relative to August and July. September is a seasonally more volatile month historically and the news this month didn't disappoint. From COVID headlines to default risk out of China (Evergrande – the country's second largest property developer) to Fed tapering discussions to fiscal policy disagreements on, well, everything (infrastructure, budget reconciliation and debt ceiling) – there were plenty of reasons for more volatility. ***Second, across all time periods, the "Average" stock witnessed a notably larger drawdown than the index itself suggesting that there was more churn under the surface.*** More specifically this suggests that the index was more stable because of its largest constituents. Remember that's because the S&P 500 is market cap weighted – bigger companies have a larger impact on the index itself. This is even more apparent today because the Top 5 constituents (APPL, MSFT, GOOG, AMZN, FB) now make up over 20% of the index alone. In short, the maximum drawdown of the Top 5 was more modest than the "Average" stock. ***Third, as volatility increased in September, the larger names in the S&P 500 started to come under increased pressure.*** That is to say that the Top 5 category started to suffer a proportionately larger drawdown relative to the "Average" stock than what was seen in July or August.

We'd argue the recent rise in interest rates has been an influencing factor on that last point. After falling below 1.2% in early August, the 10 Year Treasury Yield finished the month of September back above 1.5%. Impressively, the last two weeks of September saw a jump of over 20 bps in yield – a move of over 15%. We'd attribute this move to several factors.

- The <u>COVID delta resurgence in the US that began in June has more visibly peaked</u> given the drop in positivity rates and continued vaccination uptakes. To the extent that bonds were used as a hedge against another bad COVID outcome, this fear has been assuaged.
- In the most recent Fed meeting, <u>policymakers more overtly made mention of the need to begin the tapering process</u> (lessening of bond purchases). Less bond buying means less artificial influence holding rates lower in the Treasury market.
- The <u>concern over China's Evergrande debt default eased</u> due to reduced contagion risk (as most exposure is held outside the global financial system) and China policymakers that are likely motivated to restructure the debt in an orderly unwind.

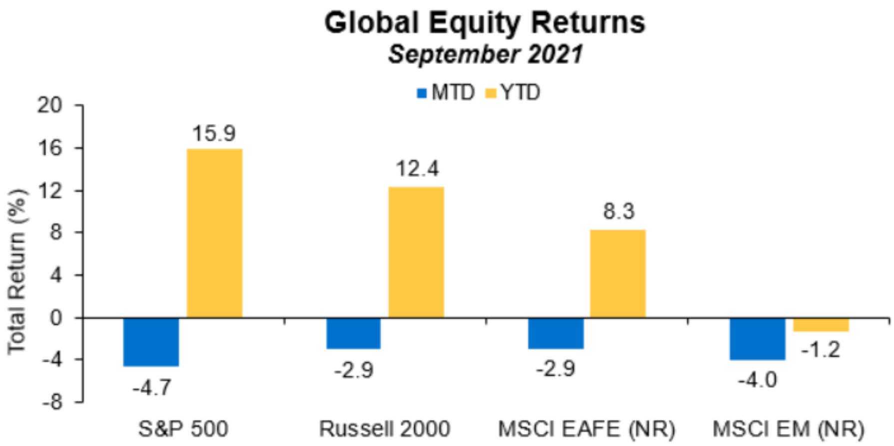


Source: Factset

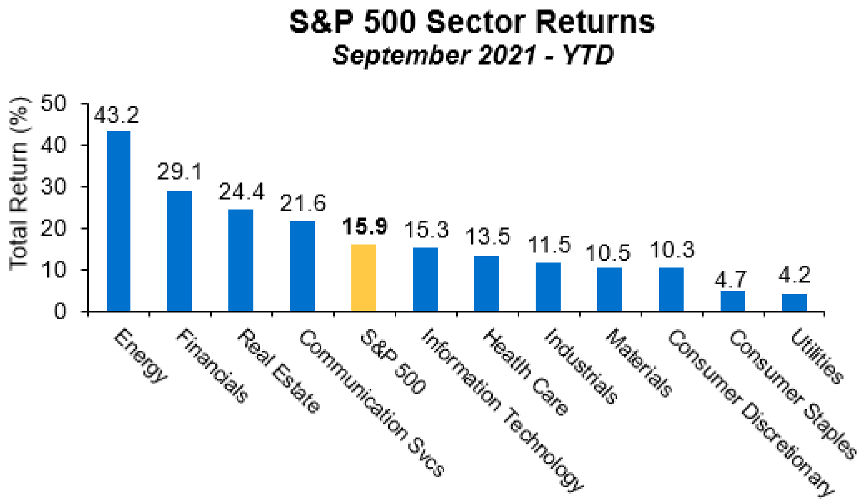
Rising rates tend to be a more obvious headwind for financial securities with fixed payments long into the future – long duration bonds – but high price to earnings (P/E) stocks can also be viewed as duration sensitive. That's because often imbedded within a higher P/E stock is the assumption of higher future earnings growth. When the interest rate used to discount that future earnings growth rises, the present value of the stock is more negatively impacted. As can be seen in the chart above, current valuations are extended for the S&P 500 index as well as for its Growth and Value counterparts. However, the valuation premium has become much more extended in the Growth index, which is where most of the largest market capitalized companies reside – Tech, Discretionary and Communication Services make up almost 74% of the S&P 500 Growth index alone! If there's a market vulnerability to higher rates, we'd argue that's where it might be most prominent.

Despite the recent volatility in September, full year returns have still indicated a reflationary bias. Real Assets outperformed Stocks and Stocks outperformed Bonds. Commodities, Real Estate, and Cyclical sectors did the best while interest rate sensitive Bonds suffered the most.

Stocks

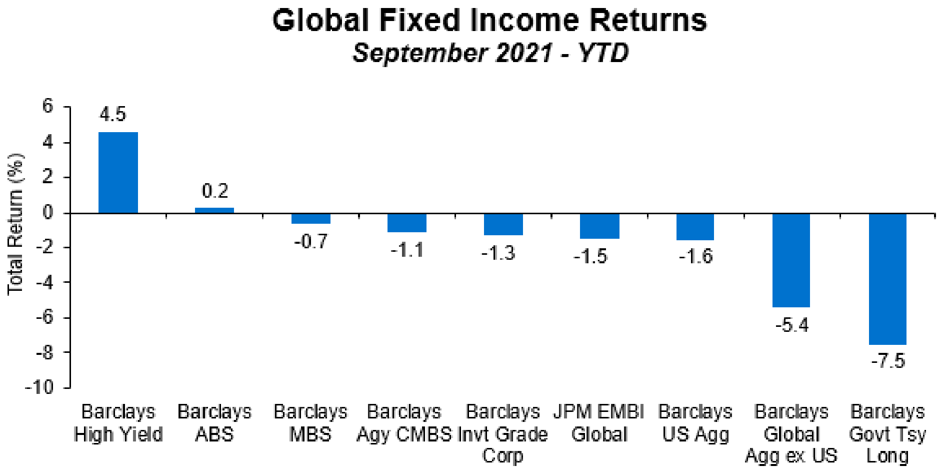


Global equities suffered a selloff in September amid still mostly strong year-to-date totals. Here at home, the most expensive area – US Large Caps (S&P 500) – was hit the hardest in the month. Overseas, Emerging Markets (MSCI EM) were more severely impacted as a broadening regulatory crackdown in China embroiled markets. Policymakers there have taken a hardened stance on everything from education to technology to real estate. Increased regulations have become China's answer to solving for income equality and self sufficiency. Year-to-date, all S&P 500 sectors have posted positive returns. Sectors have reflected an investor preference for Cyclical exposure with significant outperformance in Energy and Financials (Cyclical Value) as well as Communication Services (Cyclical Growth). Conversely, more traditional Defensives (Health Care, Utilities) have lagged – though this reversed some in the third quarter as both sectors outperformed.

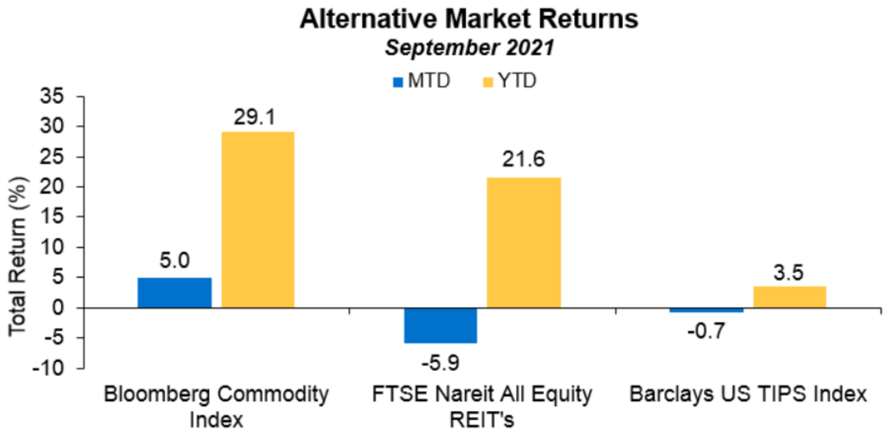


Bonds

Bond returns were mostly negative year-to-date amid rate volatility. Long-term interest rates began trending higher last August with the pace picking up in the first quarter only to give back in the second quarter before moving up again in September. Meanwhile, short-term rates remained mostly anchored by the Fed resulting in a Yield Curve that steepened in the first quarter to its highest level in over 5 years – then retraced about 40% of that move and is now trying to stabilize. Year-to-date, the more interest rate sensitive areas of the bond market saw their returns pressured the most – including long-duration Treasuries (Govt Tsy Long) – though that lessened in the most recent quarter. A stronger dollar also pressured International Fixed Income (Global Agg ex US) for the balance of the year. Meanwhile, securities with shorter durations and more sensitivity to equities outperformed, including Securitized Assets (ABS, MBS, CMBS) as well as Investment Grade and High Yield corporate bonds.



Alternatives



Alternatives posted mostly strong returns for the year albeit more mixed for the quarter and the month. Treasury inflation protected securities (TIPS) were held back by the rise in long-term interest rates though outperformed nominal Treasuries given increased inflation expectations. Both publicly traded real estate (REIT's) and Commodities generated among the best results for the year. The former has been viewed as an attractive reopening opportunity though with some defensive yield characteristics. The latter has benefited from rising Energy, Industrial Metals and Agriculture prices.

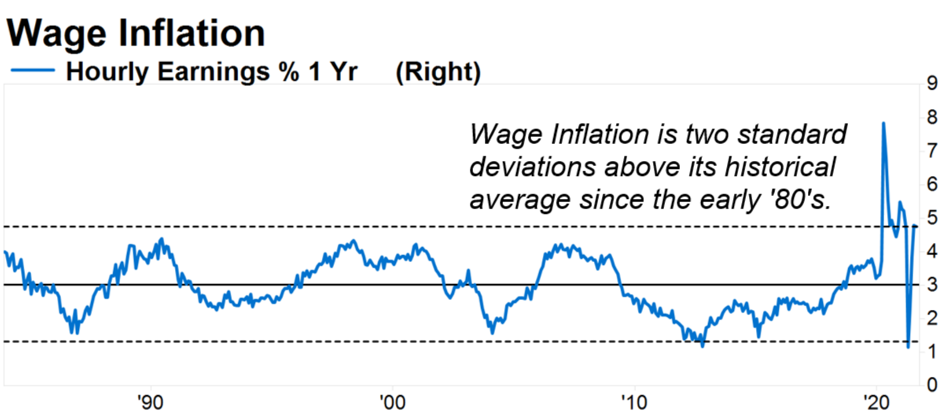
Market Outlook

Coming into this year, our business cycle outlook has continued to be best defined by the phrase "From Red Lights to Green Lights". Having a medical solution to the medical problem is ushering in an economic reopening. This, combined with record levels of stimulus, is expected to generate sizeable GDP and earnings growth in 2021 (see table at right).

		Red Lights	Green Lights
Indicator	**2019**	**2020**	**2021 e**
GDP (yoy)	2.6%	-2.3%	5.9%
Unemployment Rate	3.6%	6.7%	4.8%
S&P 500 EPS (yoy)	4%	-22%	62%
COVID Cases	N/A	19.1m	?

Source: Factset; S&P Dow Jones. S&P 500 EPS growth based on operating trailing twelve months actuals and forecast. 2021 GDP and Unemployment Rate estimates are projections produced by the Federal Reserve as of September 2021. COVID case count from www.coronavirus.jhu.edu as of 12/28/20.

From an investment perspective, we still think having a reflationary tilt in portfolios provides an opportunity. That is to say that we think inflation and/or nominal growth will remain stickier than expectations. A federal budget deficit today that only rivals that of World War II, along with de-globalization trends, and the Fed's FAIT (Flexible Average Inflation Target) policy are all structural reasons to support this theme. The money supply is over 30% higher than where it was pre-pandemic and its still growing at almost twice the historical average. More money in the system means more money gets spent fueling price increases. As can be seen in the chart below, more money has also worked its way into wage inflation – which is the highest its been since the early 1980's and is near two standard deviations above normal over that same time period. While we do think the transitory portion of inflation moderates from here, the surprise might be the level at which inflation (and nominal growth) normalizes relative to long-term interest rates. The disconnect between the 10 Year Treasury Yield and CPI is also near two standard deviations relative to history dating back to the early '50's. Similarly, the gap between the 10 Year Treasury Yield and nominal GDP growth is the widest ever over the same time period.

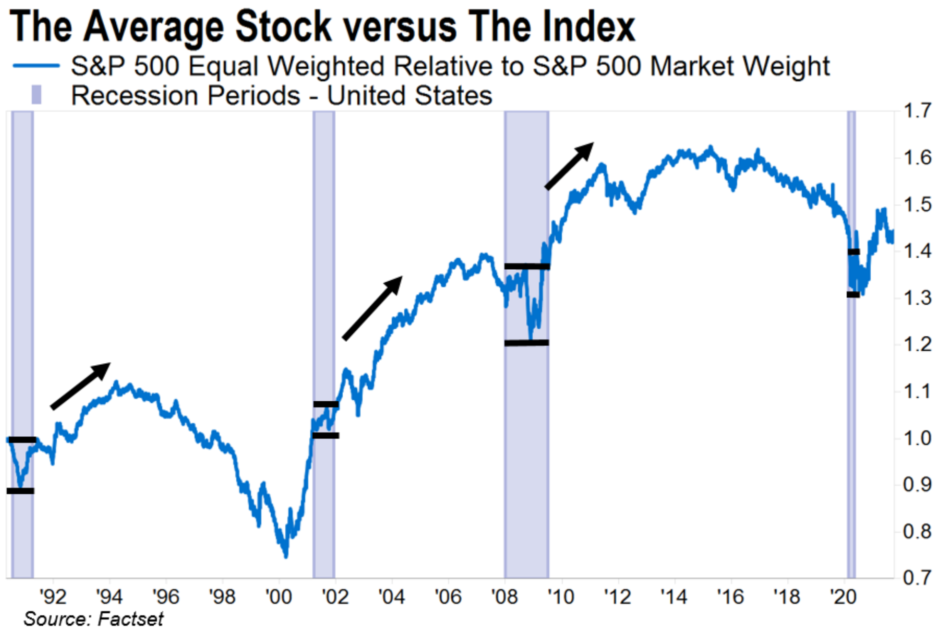


Source: Factset

<u>All of this suggests opportunity exists for reflationary pockets in the market</u>.

From a cyclical perspective, things are a bit trickier. Liquidity is still robust but likely has peaked. Fundamentals are very healthy but are set to slow from here. The offset is that economic expectations have been reset and equity sentiment gauges have come off the boil as investors have anticipated the mid-cycle slow down to a degree. The investment landscape remains expensive in an aggregate sense but some pockets are much more overvalued than others. Rising rates are likely the fulcrum to this disparity. ***In short, the market call may be a little less important than the intricacies of the underlying market – "it's not a stock market but a market of stocks".***

As we noted earlier, the "Average" stock has come under more pressure in September and has been underperforming the last couple of months. This can be seen in the chart below which graphs the S&P 500 Equal Weighted Index to the S&P 500 Market Cap Weighted Index. Outperformance in the latter can be seen in the line moving lower in the chart. That is to say that recently the larger market cap companies have outperformed. Taking a look back at history, we've seen similar midcycle slowdown periods coming out of recessions but, notably, the Equal Weighted Index tends to reassert its outperformance as the fundamentals and sentiment conditions refresh. ***If today plays out similar to history, having a more diversified mix of stocks relative to the more concentrated market cap weighted index might be additive.*** That continues to be how we're positioned within the US Large Cap space in particular – underweight the most expensive and concentrated pockets of the market.



Meanwhile, we want to keep our head on a swivel and be cogznizant of risk. After all, Stocks are up significantly off the lows from over a year ago. As such, we recognize that investors may not want to be as aggressive in positioning as they were to begin the year – for the following reasons:

- Year Two of a cyclical bull market has historically ushered in more volatility (albeit positive returns). Through the first six months of Year Two, we've seen comparable historical FULL year returns with about half of the volatility.
- As we get closer to the end of the year, corporate profit growth is likely to slow. While this is not a major negative for market returns, in aggregate, it does tend to signal a rotation under the surface – having implications for sectors and risk factors.
- Stock valuations, in aggregate, are elevated in an absolute sense and may become more so in a relative sense. The equity risk premium may look less favorable if rates rise.
- Policy conditions are likely to be less favorable over the next 12 months than over the past 12 months (less liquidity and more potential headwinds for corporate earnings).

In short, we advocate maintaining a reflationary tilt in one's portfolio while managing the degree of that tilt. Accordingly, several times this year – including early in September – we've trimmed our OW to risk assets (via Equities and Alternatives) while maintaining diversification with lower volatility securities (via US Core Fixed Income and Diversified Alternatives).

Within equities, our OW's continue to favor a pro-reflation bias. Previously, we've increased our exposure to a modest OW in International Markets. We've also previously increased our US Small Cap exposure to an OW and have shifted toward more of a cyclical value sector tilt within our (UW) US Large Cap exposure (though recently have shifted some of that value tilt toward higher quality companies).

Within fixed income, to mitigate some portfolio risk, we remain UW the most cyclical parts of the bond market (High Yield and Emerging Market Debt) but our US Core managers are OW credit and UW (defensive) treasuries. We also continue to carry a shorter duration bias (less interest rate sensitivity). Our US Core Fixed Income exposure remains an OW supplemented by our UW position in International Fixed Income which remains a beneficiary of a weaker dollar environment.

Within alternatives, we've recently taken profits by trimming some of our exposure to real assets but remain overweight as a way to bolster inflationary hedges – thus we're OW to Real Estate and Commodities. Meanwhile, we are also OW to Diversified Alternatives which provide some hedge against market volatility.

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