



Quarterly Investment Newsletter

Third Quarter 2020

Third Quarter 2020 Key Takeaways

Despite some choppiness in September, the S&P 500 Index rose 8.9% in the quarter and has recovered all its losses for the year. Without the FANMAG stocks (Facebook, Amazon.com, Netflix, Microsoft, Apple, and Google/Alphabet), the S&P 500 would still be down for the year.

Underneath the surface, mega-cap growth names continue to lead the U.S. market. They now dominate the index, but their outsized past returns have come from their ascension to the top, not from owning them once they were already there. Owning the largest stocks has badly lagged owning the diversified index over time.

The U.S. mega-cap growth effect has driven the relative returns of U.S. versus foreign stocks this year. Developed international stocks gained 6.0% this quarter, almost three percentage points behind U.S. stocks, though, emerging-market stocks outperformed U.S. stocks with a return of 10.2%. Both groups still trail U.S. stocks year to date.

Bond markets were calm throughout the summer, thanks in large part to the Federal Reserve's extremely accommodative monetary policy. With Treasury yields unchanged, core investment-grade bonds gained 0.6% in the third quarter.

In riskier segments of the bond market, high-yield bonds and floating-rate loans were each up over 4% but remain slightly negative for the year.

Going into the final quarter of 2020, multiple crosscurrents and uncertainties are presenting both investment opportunities and risks.

There are reasons to be cautiously optimistic: An economic recovery is underway. A vaccine is likely in 2021. Monetary policy is extremely supportive. And U.S. stocks are cheap relative to bonds.

There are also reasons for caution: Election uncertainty could cause financial market volatility. A disputed result or ballot-counting delays could mean greater volatility than usual. The pandemic remains a significant societal, economic, and financial market risk. U.S. stocks are expensive relative to history. And there is always the potential for a geopolitical or other unknown shock.

Our watchwords for portfolio construction and positioning remain *balance* and *resilience*. Our portfolios are balanced and diversified across multiple dimensions. And we believe they can provide strong returns in our base-case and more optimistic economic scenarios, while still maintaining resilience should a more challenging scenario play out.

Investing in a way that accounts for the wide range of plausible outcomes requires discipline, patience, and a willingness to stand away from the herd at times. It can feel uncomfortable to stay the course, or add to equities, when markets are plunging or to care about valuation and not chase markets higher when they are soaring. But in the end, this is the best approach we've found to achieving one's long-term investment goals.

Third Quarter 2020 Investment Letter

Market Recap

Despite some choppiness in September, equity investors were treated to solid gains during the third quarter. The S&P 500 Index rose 8.9% in the quarter and has recovered all its losses for the year. Underneath the surface, mega-cap growth names continue to lead the U.S. market. Without the astonishing 42.5% year-to-date price return of the six so-called FANMAG stocks (Facebook, Amazon.com, Netflix, Microsoft, Apple, and Google/Alphabet), the S&P 500 would still be down for the year.

The outperformance of these top names means they now dominate the index. Market concentration is not unusual, but with the top 10 stocks in the S&P 500 making up 28% of the index, it's extreme today. The important investment takeaway is to not be lured into chasing the returns of what has worked well in the recent past. These companies' outsized past returns have come from their ascension to the top, not from owning them once they were already there. Owning the largest stocks has badly lagged owning the diversified index over time.

Nevertheless, this U.S. mega-cap growth effect is driving the outperformance of U.S. stocks versus foreign stocks this year. Developed international stocks gained 6.0% this quarter, almost three percentage points behind U.S. stocks, though, emerging-market stocks outperformed U.S. stocks with a return of 10.2%. Both groups still trail U.S. stocks year to date.

Some of this relative performance is deserved. Unlike in the dot-com era, today's large U.S. growth firms have created real economic value. This has come at a time when growth has been scarce and interest rates low, so investors have been willing to pay up for their growth. That said, a durable economic recovery taking hold could be the catalyst for investors to turn away from these highflyers and favor undervalued stocks in out-of-favor industries and overseas markets.

Bond markets were calm throughout the summer, thanks in large part to the Federal Reserve's extremely accommodative monetary policy. Treasury yields were unchanged, and core investment-grade bonds gained 0.6% in the third quarter. Fed officials say they are now targeting "average inflation" of 2% and have signaled that they do not expect to raise rates at least through the end of 2023. Since inflation has not topped the Fed's target in a decade, many market participants expect low rates and supportive policy to continue for a long time. In riskier segments of the bond market, high-yield bonds and floating-rate loans were each up over 4% but remain slightly negative for the year.

Going into the final quarter of 2020, multiple crosscurrents and uncertainties are presenting both investment opportunities and risks, over the near term and medium to longer term. A unique U.S. election approaches in November. The market doesn't like uncertainty, so the weeks leading up to the election and afterward may be volatile. But history shows any election-year declines are usually short-lived and the political party in power is not a significant driver of investment returns. Political views have no place in our investment process, and we don't attempt to predict the short-term market reaction to elections (or any short-term event). There are simply too many *other* factors that impact markets over time. Instead, we stick to our longer-term analytical framework in which we consider and weigh multiple macro scenarios and assess the potential risks and returns for numerous asset classes and investments in each scenario. The fundamentals are what really drive long-term market performance.

Looking through the election, there are reasons to be cautiously optimistic about the investment prospects for global equities and corporate bonds. And there are reasons for caution.

Reasons for Optimism

An economic recovery *is* underway. Economic data and forecasts are improving (see the growth projections from the Organisation for Economic Co-operation and

Development, or OECD, in the chart above). All else equal, rebounding economic growth here and abroad should support equity and corporate bond markets.

On the virus front, the speed of progress in vaccine development is promising. An effective and widely distributed vaccine would allow economic activity to return to its full pre-pandemic potential.

And this year's extraordinarily supportive monetary policy (asset purchases and lower interest rates) and huge fiscal stimulus, both here and abroad, were key drivers of the speedy recovery in markets and the global economy. Central bank actions and government spending don't *guarantee* the absence of volatility, another bear market, or recession. But there are programs now in place, especially in the United States, that could step in to help the functioning of markets and the economy in case volatility returns or setbacks occur.

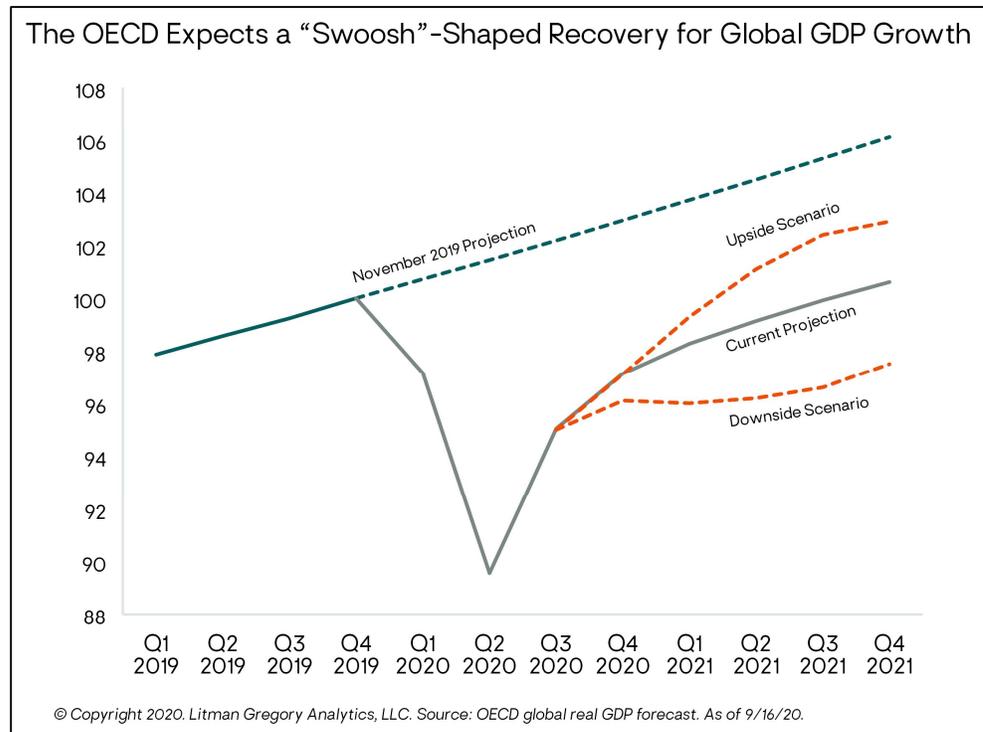
Reasons for Caution

It remains to be seen how strong the actual economic recovery is and how much of it is already discounted in current prices. In our view, there is as much room for disappointments as there is for positive surprises.

While vaccine development steams ahead, the potential remains for a large resurgence of COVID-19 in the fall and winter months. We are seeing this already in Europe, and the infection rate has popped up slightly here in the United States recently. This raises the risk of renewed shutdowns and another economic downturn.

Monetary policy is supportive, but more fiscal support from Congress is likely needed to further protect citizens, help businesses survive, and shore up state finances. If it doesn't happen, it will be a hit to fourth quarter economic growth, which could in turn impact markets.

Finally, there is always the potential for a negative geopolitical shock. The U.S.-China conflict and Brexit come to mind, but a new development could emerge that no one is considering (like the pandemic did earlier this year).



Portfolio Positioning

We are very comfortable with how our portfolios are constructed, as detailed below. The watchwords of our current positioning remain *balance* and *resilience*. Our portfolios are balanced across multiple dimensions: domestic versus international stock exposure, growth versus value strategies, interest rate risk versus credit risk, traditional versus alternative investments. And we've designed our portfolios with the goal of generating potentially strong returns in our base-case and more optimistic economic scenarios, while maintaining resilience in a more challenging scenario.

On the equity side of our portfolios, as a reminder, we were underweight to U.S. stocks and stocks in general going into the pandemic due to unattractive valuations. In March after an initial large decline, we added to U.S. equity exposure at more attractive prices. Since that time, U.S. stocks have appreciated strongly, outperforming most other investments. They have soared more than 50% from the March low and again look historically overvalued. Forward price-to-earnings (P/E) and median P/E ratios are approaching dot-com-bubble highs. Nothing prevents valuations from rising even further near term, but we know high starting point valuations have a strong *inverse* relationship with future long-term returns. Overvaluation tends to not matter ... until it does.

But while U.S. stock valuations look expensive relative to history, they look cheap relative to bonds. Bond yields are extremely low, which forces investors to allocate more to stocks, pushing stock valuations even higher or keeping them higher for longer. Cheap relative valuations, in addition to a supportive Fed and plausible optimistic scenarios in which U.S. stocks *can* deliver decent returns, keep us from a larger underweight. We don't want to be too underweight to U.S. stocks as there could be a significant opportunity cost if they continue to perform well.

Our overweight to emerging-market stocks offsets some of our underweight to U.S. stocks. And we hold a full strategic weight to developed international stocks. Thus, portfolios are still slightly underweight to stocks in general. We don't want to reduce our global diversification right now as stock valuations are cheaper in non-U.S. stock markets. We continue to see superior five-year expected returns there across most of our macroeconomic scenarios. Stocks being cheap compared to bonds is even more true in international markets. Plus, in a sustained global economic recovery with Fed-repressed U.S. interest rates, the odds are that foreign currencies will appreciate against the U.S. dollar. This would further enhance the returns of international assets for U.S. dollar-based investors.

On the fixed-income side, core bonds are an important shock absorber in a negative economic or geopolitical shock. However, as mentioned before, yields are very low and even a modest increase in interest rates could lead to negative short-term returns. To better diversify our fixed-income allocations, we have invested in actively managed flexible bond strategies with higher expected returns and lower interest rate risk. The tradeoff is they will not hold up as well as core bonds in a deflationary event. But we have taken this into account when setting your portfolios' total equity risk, hence the slight underweight to stocks.

The third broad component of our balanced portfolios comprises trend-following managed futures strategies. These investments further diversify equity and bond market risk and are intended to generate returns over time that are much better than we expect from core bonds and potentially competitive with equity returns. In a bull market, these alternative strategies will likely trail stocks. But in a sustained bear market, we expect them to provide protection and partially offset losses in risk assets.

Closing Thoughts

History shows markets are consistently unpredictable. Adding to the uncertainty are the unprecedented circumstances, challenges, and structural changes the global economy is currently facing.

Having a high degree of conviction in any single outcome strikes us as imprudent. Instead of trying to continuously predict the future, we are focused on building resilient portfolios across multiple plausible

scenarios, accounting for a range of shorter-term risks but keeping our primary focus on the medium- to longer-term fundamentals that ultimately drive investment returns.

Investing this way requires discipline, patience, and a willingness to stand away from the herd at times. It can feel uncomfortable to stay the course, put capital at risk when markets are plunging, or refrain from chasing overvalued markets higher when they are soaring. But in the end, this is the best approach we've found to achieve long-term investment goals.

-Reiner Financial Group (10/12/20)

Securities offered through Cambridge Investment Research., A broker/Dealer, Member FINRA/SIPC and Investment Advisor Representative, Cambridge Investment Research Advisors, Inc., a registered Investment Advisor. Reiner Financial Group, LLC and Cambridge are not affiliated.

Reiner Financial Group's Investment Newsletter

Certain material in this work is proprietary to and copyrighted by Litman Gregory Analytics and is used by Reiner Financial Group with permission. Reproduction or distribution of this material is prohibited and all rights are reserved.