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TRANSCRIPT: Q4 2020 Market Update

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Steve Elwell: Hey everybody. This is Steve Elwell, Chief Investment Officer of Level Financial Advisors. And this is your Fourth Quarter Market Commentary. It was a fantastic quarter for the stock market. There was all sorts of news and events happening this quarter, and I'm going to get into that in a little bit. But first let's walk through how the U.S. stock market did, international stocks did, emerging

[00:00:30] markets, all the various categories. So the U.S. stock market as a whole up about 14 and a half percent for the quarter, which is fantastic. International stocks did even better. Emerging Market Stocks did even better than those two categories, and Global Real Estate had a good quarter as well.

Specifically, if we dive a little deeper here, what led the way was a big resurgence in small stocks.

[00:01:00] You can see that in the Russell 2000 Value Index and the Russell 2000 Index, which of course is the 2000 smallest stocks in the U.S. At 33% and 31% for the fourth quarter. That's really a pretty phenomenal turnaround and recovery for a three month period.

Emerging markets followed, specifically emerging markets Value Stocks did really well in the fourth

[00:01:30] quarter. International stocks, like I said earlier, did really well, depending on which category you're looking at, earning anywhere between 17 and 20%. And there at the bottom, you kind of see the S&P 500 Index earning 12%, which is a little bit of a laggard compared to the U.S. stock market as a whole, compared to all the other stock categories. I would keep in mind that the S&P 500, for the first nine months of the year, both in the downturn that happened in March, but also the recovery

[00:02:00] that happened in the second and third quarter had pretty much led the way. So as we really had a big push forward in the stock market, it's not terribly surprising to see other categories that had more attractive valuations, really bounce upwards on the good news that was received in the fourth quarter.

[00:02:30] And I'm going to jump into that in a second, but specifically as I look at, small stocks, we had, kind of had a lot of thoughts through March as the downturn hit its peak on the 23rd of March, about just mathematically, how much would a small stock or small value stocks have to earn just to get back to even? And the numbers were huge. I mean, the numbers were like, if I remember off top of my head, like 80% to just get back to even.

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And so if you were off the mind that, that was eventually going to happen, whether it was six months from now or three years from now, either way the returns both in pure terms, cumulative returns versus annualized returns, either way, they're going to look really attractive if this category recovers. And so here's a quick chart from March 23rd the bottom, through December 31st, the

[00:03:30] end of the year 2020 for DFA U.S. Small Cap Value, which as many of you know is one of the staples of our portfolio for most people, depending on how tax sensitive your portfolio is.

But this particular fund since March 23rd, through the end of December 2020, 94% return, almost

doubled from the bottom. That I think is, I'm not showing this to say, look how good this fund is
[00:04:00] doing, maybe we should buy more of it or something like that. I'm showing this to simply say that, how dramatic the downturn was and how dramatic the recovery needed to be, just to get back to even, and it actually happened and not only happened, but happened in nine months. And it really kind of almost reminds you of how unbelievable of a year 2020 was economically, stock market wise, global health wise. I mean, just what undoubtedly will be one of the most wild years that any
[00:04:30] of us will probably ever experience and certainly we'll never forget. So, we're glad to see that recovery continue to happen.

Some people may say, well, tell us what's driving that? And as usual unexpected good news ends
[00:05:00] up being the driver of big stock market bounces. And so, any news that's already known is already priced into the stock market, that, that information digesting machine, that the stock market is, that millions and millions of investors consider every piece of new information at every moment when they price Google stock or Apple stock or any other stock you want to pick, is just so impressive. It's really impressive and it's highlighted time and time again.

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So specifically, if we look at the fourth quarter, there was a lot going on. I mean, no question there was a lot going on, top of everybody's mind was the election, and I'm going to hop into that in a second. But right in early November, and then through the back end of November, we received two unbelievable pieces of information from the medical community, that phase three trials for the vaccines for Pfizer and Moderna's vaccine came in at 95% effectiveness. Which my understanding is
[00:06:00] well above substantially above what the hope was, the best case hope was, for these vaccines, which I think was in the range of 60 to 70% effective is what they were kind of hoping for.

So to have them be that effective through phase three trials, and then move on later in to
[00:06:30] December, to emergency FDA approval. And actually start shipping and delivering and administering the vaccines is truly a turning point in the pandemic. There's just no question about it. So to have that news, not only come out, but be much better than expected, is one of the key drivers of why the stock market has such a good quarter.

[00:07:00] And if you were the average investor that's not something... You knew the trial results were coming, you don't know exactly when they're going to be delivered, you don't know exactly what the effectiveness is going to be, and you can have your best guesses. But to get results like that undoubtedly the stock market immediately priced in. Then you saw it, the day that those announcements were made immediately priced in the effect that good news was going to have.

And so that is one of the major drivers of why the fourth quarter was so good. There were two
[00:07:30] other pieces of information that I think were impactful in the fourth quarter among a whole bunch of other things. But late in the year we finally had Congress and the president sign another stimulus package for another $900 billion, including checks, payment checks out to individuals again, and to have increased unemployment benefits that were about to stop.

[00:08:00] So we had that stimulus come along, which obviously is another shot in the arm for the economy to keep things moving, keep things going, keep people floating who really need help. So that

happened later in the quarter. And then obviously back in November, we had the election, we had... It took a little while for all the results to be counted, but ultimately we had the election happen. We had the results come in, we had Congress certify their results and work their way through that. And so ultimately the market from an investment standpoint had that worry behind it. That, what was the result of this going to be? And how was it going to go? And we had talked a lot in the last commentary about people asking questions specifically of, Hey what strategy should we change for the portfolio?

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[00:09:00] Should we take more risks? Should we take less risks? Should we switch around where we put money in different investment categories based on the election? And our advice was what it always is for every election, whether it's midterms or whether its presidential elections, which is, this is not... It's a big event, but it is not one that drives changes in your portfolio and how you structure it. Because ultimately even if you can predict what's going to happen, you can't predict how people and investors are going to react to that. And you also can't predict the next four years of economic in stock market returns and profits and earnings. You just not going to be able to get all that information from the results of the election. And we've used this example before, but I'll reiterate it again. Widely prevailed or prevailing advice and expert thought and recommendation was when Trump won the election in 2016, the bank stocks and energy stocks were going to be the place to be due to less regulation and less taxes.

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And less regulation and less taxes actually happened, that part came true. Bank and energy stocks did well in the fourth quarter of 2016. That was first couple of months after the election happened. But going forward after that bank and energy stocks were some of the worst performing categories of the stock market for the following three and a half years. So if you had made those changes with the expectation that, I'm going to correctly call what's going to happen from a legislative standpoint.

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And that's going to translate into stock market returns and I'm going to make more money because of it. It's just one of a million examples where you can get the thesis right. You can actually predict what's going to happen correctly and still get the investment aspect wrong. And so here's one chart that I like to show that for this fourth quarter here, and this is just simply the Vanguard S&P 500 Index, which is what most people call the stock market in the U.S. And as you look at it, this goes from November 3rd, the date of the election through the end of the year.

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And ultimately what you end up seeing is that the stock market just kind of moved forward from a relief standpoint, knowing that the election was over and there was no huge wild swings, upward or downward. You hear all these predictions about, oh, if this person wins, the market's going to crash, or if this person wins, the market's going to go through the roof. And the stock markets view more is, oh, this election is over. And so now we don't have to think about this any more, and we can... The information machine can move forward to processing things like vaccine news, stimulus package, corporate profits, and reports and earnings for each quarter. So fortunately the election again, had very little effect ultimately on what's happening. And the stock market did not cause any major crash or direction change downward.

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[00:12:30] One other thing is I move beyond that. And we've touched on this a little bit before too, but I want to sort of circle back to it is, at this current moment, the 10 largest stocks in the S&P 500 are really driving a large percentage of how the market moves each day and what the valuations of the S&P 500 specifically are. So when I say the top 10 companies, I'm talking about companies that you're all using and well-aware off. Apple, Microsoft, Amazon, Facebook, Google, Tesla, Berkshire Hathaway, Johnson and Johnson, JP Morgan, and visa. And I've got a couple of charts here that

[00:13:00] visually might be a lot to digest, but are certainly interesting to look at. The top 10 stocks and what their current PE ratios are, which is kind of a price to earnings measure of how expensive they look. The higher the number, the more expensive they look. How expensive they look at the moment relative to their average over the last 25 years.

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And you can kind of see, as you look at the top 10 compared to the remaining 490 stocks in the S&P 500. That the top 10 look a little rich in valuation relative to everything else. And the top 10 have become by size the largest they've been on record over the last 25 years at about 28%. That would be the chart at the top right here. But, fortunately there's some explanation for that, which is the

[00:14:00] earnings of those top 10 have contributed also a fairly high percentage of the overall S&P 500 earnings. So what I'm trying to show here is that these top 10 companies, specifically the ones at the top, Amazon, Microsoft, Apple, Facebook, Google, really are kind of dominating the movement of the S&P 500. And it's been that way for like the last three years.

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That's not something that's new. That's part of the reason why the S&P 500 has beat, basically every other stock category out there. Is because these large companies are sort of eating everything else. They're buying other companies, and eating them up. They're sort of continuing to grow their own market share. And as we went into stay at home, locked down through the

[00:15:00] pandemic, we were using their services more than ever. Specifically, ones like Amazon and Facebook usage went through the roof. Ultimately, what happens is that, that doesn't last forever. Right? Trees don't grow to the sky, would be the old saying, especially as we get out of the COVID world I suppose. If we ever get back to a more normal scenario with no lockdowns and no restrictions, you would expect usage of Amazon and Facebook and things like that, potentially to at

[00:15:30] least revert back downward somewhat, knowing that people don't have to be as reliant on their services anymore, for various different things.

So I wanted to highlight that so I can highlight the next thing, which specifically is, from a valuation standpoint, as you look at all the different categories out there, ultimately what it looks like and

[00:16:00] has looked like for a while, but its continued to get more dramatic is, how less, how cheaper, I guess, is not really the word I want to use. But valuation wise, how much more attractive, things like emerging markets and international stocks are. The price you're paying to get earnings is quite a bit lower, dramatically lower, not simply than the S&P 500, but what the average has been, when

[00:16:30] you compare the two valuations of emerging markets to the S&P 500, and international stocks to the S&P 500. You have on the left emerging markets, you have on the right Developed Markets, which is basically like Europe and Asia.

[00:17:00] You can continue to see the gray line go down and down and down, where this middle dotted purple line is the average. We really have moved pretty far dramatically. The pendulum is swung pretty dramatically downward, where the valuations of emerging markets and international stocks relative to the S&P 500 is really basically for the international stocks, at the lowest point it has been in the last 20 years. And for emerging markets, pretty darn close to the lowest it's been over the last 20 years. And keep in mind, emerging markets had their big currency crisis in the late 90's. So [00:17:30] they were... Late 90's early 2000's, really at a dramatically low place because of that crisis that had just happened. So this is not me saying that emerging markets or developed markets are about to try and see S&P 500, but valuation wise, there's a pretty big difference between what you're getting when you buy the S&P 500 and what you're getting in these other categories.

[00:18:00] Those trends can last for a while, they have, for the last few years, you can see that. This isn't the first time we've talked about emerging markets and international stock compared to the S&P 500. But at some point, the pendulum swings back and the other favor. It has happened in the past before. It probably will happen again. That doesn't mean it's going to be this quarter or this year, but it is something that we pay attention to and is still on our radar. And I set up those two [00:18:30] conversations about the top 10 stocks and the S&P 500 and valuations of international stocks compared to the S&P 500 to kind of go into this final point. And this final point is a Vanguard, the asset manager that we'd like to use and a lot of people like to use. And they manage about 6 trillion with a T, dollars for investors.

[00:19:00] And they come out with a 10 year forecast, every year they update it based on current valuations and they say, here's what we think the range of results might be for the next 10 years for these different categories. And so we've been paying attention to this for a while as well. And they seem to come to the same conclusion that you might be coming to, as I'm talking about these sort of various comparisons, which is specifically for different stock categories. They expect the global [00:19:30] stock market, so that's U.S. and the rest of the world, the entire world basically, over the next 10 years to earn somewhere between like four and seven and a half percent. Which is a reasonable expectation, a little lower than what the last 10 years would be for sure, because the last 10 years have been pretty good. But when you dial down to different categories, their expectations are quite low for big U.S. growth stocks and higher for international stocks and value stocks.

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And there's a pretty big simple reason for that, which is the same story that was just told with the previous two slides, which is big U.S. growth stocks, specifically Apple, Amazon, those same tech companies. Price wise appear a little overvalued relative to history, and other categories appear a little undervalued relative to longer-term history. And so their expectation is the same that we laid [00:20:30] out with those other slides. Which is at some point that corrects. There's some point there is a mean reversion there. And this kind of dials back to the whole idea of having a diverse portfolio and sticking with asset classes through thick and thin, because generally each year, something different is leading the way and you can't predict in advance, which one is going to lead the way. So the idea of having exposure to all sorts of different investment categories means ultimately that [00:21:00] the ones that end up being the winners, you can trim some of the profits off, and the ones that are this year's losers, you can rebalance and add more allocation to, in hopes that they might be

tomorrow's winners.

[00:21:30] And so that process ends up for an investor, specifically, an investor who's retired and living off their savings, is extremely important because the alternative is saying, I'm going to make a big bet on whatever stock category or a couple of stock categories that you think are going to do well. And if you are on the right side of that, then everything's fine. And you've made a lot of money and good for you. If you're on the wrong side of that, you have an unacceptable result, which is I do not participate in whatever category was the leader, and my returns are subpar, and that may risk my retirement and may mean that I run out of money before ultimately that I pass. And now I've got a [00:22:00] big problem. Right? My retirement savings have been drained because I made a big bet and I got it wrong.

And so I just wanted to set the table, that was a big lead up through several different slides to get there, but I wanted to set the table for, why we built the portfolios the way we have, and why we [00:22:30] continue to hold asset classes that, maybe over the last couple of years have not kept up with the S&P 500, because the expectation is at some point, the S&P 500 becomes the laggard. And this quarter was a great example of that. It's only three months so that doesn't mean that, now all of a sudden the S&P 500 is going to be the worst category going forward for the next couple of years. It doesn't mean that. But it certainly means that, trends change and leadership changes and what categories are doing best changes.

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And so we need to be conscious of that when we're investing, specifically investing for retirement. So, with that said, that's kind of the Fourth Quarter recap. I do have a couple of housekeeping items I want to remind people of. If you're listening to this now it's February, and so you will be in the midst of tax season, preparing for tax season.

If you need any information from us that we haven't already sent you, or you have questions, or your accountant has questions about something specifically with your tax situation, don't hesitate [00:23:30] to give us a call. When you finish your tax return, it's extremely important that you send us a copy of that. That is one of the most effective tools for us to try and help you save money, whether that's planning for the 2020 tax return or the 2021 tax return or long-term tax planning which is really where big savings can show up, it's extremely important we have a full copy of that tax return.

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So when you finish it, or if you're about to finish it and submit it, please send us a copy so we can take a look because it's extremely important for us to have that on record. And then lastly, I want to highlight that, with this most recent stimulus that's been passed in December and with the stock market recovering and moving to new all-time highs, we are back to a normal 2021 schedule for required distributions. There is no waiver for 2021, like there was for 2020.

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So if you're interested in taking a required distribution, let us know. And lastly, tax planning wise, now that we see the results of the election, it's certainly possible that there will be some legislative changes regarding the tax code and regarding a state tax exemptions. And so we are going to be very conscious of any changes or proposals that look like they're going to pass, so we can provide

[00:25:00] analysis, and we can look at each client's individual situation and see if any changes are warranted for you. So that is on top of mind for us to discuss with clients this year.

So with that said, thanks for listening. And we look forward to talking to you next quarter. Thank you.