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TRANSCRIPT: Q1 2021 Market Update

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Steven Elwell: Hi, everyone. This is Steven Elwell, the Partner and Chief Investment Officer of Level Financial Advisors. And this is your first quarter of 2021 commentary. So let's jump right in. Another good quarter for the stock market as cases in the US have been generally trending downward and vaccination rates have been trending upward and the stock market is continued to reflect that optimism that the economy will continue to reopen and start to get closer to normal.

And a lot of the economic data points have confirmed that that is starting to happen here over the last three months of 2021, the first three months of 2021. So when we look at the stock markets specifically, we see that US stock market is up about 6.35%. international and emerging market stocks did a little bit worse than that, but still positive. Global real estate had a good quarter as well. And the bond market actually had a pretty bad quarter. We're going to talk about that a little bit later, but a little bit of a rough quarter for bonds in particular. Now keep in mind they had a fantastic 2019. So giving back a little bit of the profits that had been earned on that side of the portfolio.

This first quarter had one major piece of news come from Congress and the resident and new administration as they pass the American Rescue Plan, which if you have tuned into some of our other video series over the last couple of weeks and months, you would have seen all the different benefits that are coming out of that particular piece of legislation. So that would include extending unemployment benefits, expanding child tax credits and deductions, another round of stimulus payments and expanding who receives the stimulus payments, money for local governments and states vaccination money to support the rollout.

So a whole bunch of different things built into that legislation. And if you want to look for more detail on that, you can hop over to our YouTube page or subscribe to our YouTube page. So you can see the videos that we put out on those specific parts of that particular piece of legislation. That was certainly another piece of good news that the stock market was glad to see happen and helped generally things move upward over the first three months of the year. If we look a little deeper into how specific asset classes did for the first quarter of 2021.

We can see that, again, US small cap value stocks leading the way for this quarter with a 21% return. Value stocks also did well, not just in the US but outside the US. Real estate as we already mentioned, particularly in the US did well. Not that anybody would complain about how the S&P 500 did this quarter. Again, returning somewhere around 6%. So in general, tilting a portfolio towards small stocks or value stocks paid off in a really strong way for the first quarter of 2021. So that's obviously a positive generally for our portfolios and our clients.

If you tune into these commentaries regularly, you would know that last quarter, we started

to speak about how that side of the stock market really perked up in the last three months of 2020. And we showed a little bit of information, just about the disconnect between US large growth stocks and US small cap value stocks as this gap between the performance of the two really started to get stretched. And we noted that generally those things don't last forever. I believe the quote was, "The trees don't grow to the sky." No one investment category outperforms the other or all others forever. If that happened, then there would be no investment world. There'd be no investment markets. We would all just simply buy that one thing and call it a day.

So of course we know it's not true that one thing will always outperform. And that's really what we saw this quarter. US large growth stocks were certainly a big laggard relative to the S&P 500 relative to small stocks, value stocks. Really the outperformance has shifted. The trends have changed in a pretty strong way and pretty quickly. In fact, I have a quick chart. I showed you this one last quarter. Now I want to show this has to do with US small cap value stocks, particularly the DFA USA small cap value fund, which a lot of our clients own. And previously I had shown that funds performance since the bottom of the downturn in 2020. What I'm showing now is just simply the funds return over the last two quarters. So the four starting in September 30th, and going through March 31st, 2021. And just two absolutely knock out quarters for that particular asset class in category.

So you can see the total return of that particular fund over those two quarters at 67.82% for six months. This kind of reiterate some of the things that we talk about over the long-term when it comes to investing. Often investors can run out of patience for certain asset classes if they continue to underperform for a while, whether that's six months, or a year, or even two, or three or four years. But in the markets, what's most important when you have a diverse portfolio like this, like ours is even for those asset classes that maybe have lagged for a while and you feel like are adding no real value to your portfolio's performance, the snapback as to when they might start to provide extra value compared to something like the S&P 500 can happen really quickly. More quickly than you think might be feasible and more quickly, certainly than you might expect.

And I think this is a perfect base case scenario of, here's something that I don't think most investors were expecting to outperform by that much, that fast. So we like to compare holding onto those types of asset classes to riding a roller coaster. And we'd steal this phrase from our friends at DFA is, "The best result's when you ride a roller coaster, the way that you stay safe is to stay in your seat, to not get out, to not move, to not change course." Obviously, if you do that while you're on a rollercoaster, that's a pretty dangerous move. The same story with asset classes that might be lagging something like the S&P 500 for months, quarters or years on end. You don't know when that tide will return, and you don't know how fast that tide will turn.

And in this case, that tide has turned extremely quickly. So I just want to wrap up, give a follow-up on what we had talked about last quarter, because the story has continued to an even greater extent. So that's a good news. Good news for those that have continued to hold that asset class. So I want to circle back a little bit to the bond side of the portfolio, particularly what's happening with interest rates which from our perspective, seems like maybe a little bit under the radar as to what's happening on that side. So as a general

recap, our portfolios maintain mostly short term bonds, short term, high quality bonds. And we do that because we know a couple of things. We know that from an investment perspective, we need that side of the portfolio to remain safe and not be too volatile because that's the side of the portfolio that we lean on when the stock market goes haywire.

Like it did last March. And that's exactly what we did last March with people that needed withdrawals, or just simply we were rebalancing. We took money out of the safe bonds that had not lost money during that downturn. So, as I talk about that, generally when you have longer-term bonds, the main concern that comes from that, the main enemy of long-term bonds is really just two things. Number one, inflation, which can eat away at the real return of the interest that the bonds pay. And number two, rising interest rates, which of course make bonds that are already owned with lower interest rates less attractive because new higher rates are available for those with cash that are buying new bonds. So when we look at it, the first thing I want to point out is on the bottom right of this fixed income chart here, the quarter to date, you can see that the short-term bonds for the most part, along with high yield bonds were either positive or slightly positive as you look at the short-term pieces.

As you start to look towards the bottom of that quarter to date column, you see that the US aggregate bond index and the longterm government bond index between the two, one lost a little more than 3% and the other lost 13%. interest rates have moved upward as the US 10 year yield went from about 0.95 to about 1.74. So, that's about a little less than a 1% increase. And that caused in long-term government bonds a 13% decline for the quarter. And even as you look at the column over the last year, you can see that many of the bond categories were positive. Particularly the [inaudible] category, high yield categories had a pretty good year for the last 12 months. But you can see US government bonds have lost 15%, long-term government bonds have lost 15% over the last year.

And then again, if you're going from March 31st, 2020, which is the bottom of the drop in the stock market, and the peak of the fear in the investment markets, as you go from that point until today, interest rates certainly have recovered and moved upward over that 12 months. And that has spelled bad news for long-term government bonds. So as I switch over to this JP Morgan chart, and I show on the top right of this, what I want to highlight is the impact of a 1% rise in interest rates for various US government bonds at different maturity levels. And you can see visually what's happening here is pretty clear. The shorter the term of the bond, the less likely it is impacted in the short run and as prices change, the less the impact on the value of the bond.

So if you have a two year US Treasury, which is the top piece, there a 1% rise in interest rates might cause the price of that bond to go down by 1.9%. But at 30 year US Government bond would cause a price to decline by 19.8%. And even a 10 year US Government bond would face a 9% decline if interest rates just rise another 1%, which would get back to levels that we saw before the pandemic started. So what we're highlighting here is the risk that sits out in the bond market. Should the economy continue to recover or heat up? Should inflation start to rise and should that cause the federal reserve to increase interest rates and potentially increase them by a fair amount that might spell pretty dramatic declines in longer-term and even intermediate term bonds? So from

our perspective, maintaining that strategy of keeping short term high quality bonds is very important to defend against some of the risks that lies in the bond markets at the moment. This is not us saying that we think interest rates are going to rise by 1%.

I don't know what's going to happen with interest rates. No one else does either. But I think with the amount of government stimulus that's been passed, with the amount of economic activity that's starting to resume with vaccination rates going up, cases of COVID generally trending down. Some are approaching warmer weather and all these people that have been cooped up for the last 14 months and are now sort of saying, "Hey, I want to go do all the things that I haven't been able to do now that I can go out and about and travel and visit my kids," or whatever the case may be.

I think that there is some potential risk on the bond side of the portfolio for those that own longer term bonds. And it's important to be aware of that. So that's part of the reason why we like to maintain shorter term bonds is that that potential risk of rising rates doing damage to the returns of that side of the portfolio is minimized to a greater degree by holding shorter term bonds.