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INVESTMENT MANAGEMENT

Andrew Slimmon January 2020 Equity Market Commentary

SOLUTIONS & MULTI-ASSET | APPLIED EQUITY ADVISORS TEAM | EQUITY MARKET COMMENTARY | JANUARY 2020

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Happy New Year.

In this first commentary of 2020, I will touch on several topics:

A. 2019 High Level Portfolio Strategy Review

B. 2020 Market Outlook

C. 2020 Portfolio Positioning

A. All three of our active strategies outperformed in 2019 by a substantial amount. A few key reasons:

1. As you know, we manage style-unconstrained strategies. Our ability to "opportunistically buy value" was a key factor in our active strategy outperformance. Last summer, we correctly identified that the market[1] was mispricing value stocks down to near-recessionary levels, as happened in 2011 and 2015. We therefore increased our value exposure substantially by the end of the third quarter. As the recession call was ultimately rejected by the market in Q4, value stocks outperformed.

2. At the same time that value stocks were cheap, defensive stocks were ridiculously expensive, reflecting a high level of fear. Historically, whenever the "fear factor" has achieved this elevated level, the market[1] has always broken to the upside.[2] Count 2019 as yet another repeat. We reduced our defensive exposure in order to increase value stocks by the end of the third quarter. The defensives woefully underperformed in late 2019.

3. In our global strategies, we were confident that Asian technology stocks would close the valuation gap with their US counterparts. Investors sold this group substantially given fears of the Chinese/US trade wars and commensurate worries of a weak Chinese economy. As the "phase one" deal was finalized in late 2019 (no surprise, given that we are entering an election year), Asian technology stocks substantially outperformed their US counterparts.

B. We hosted a 2020 Market Outlook webcast on Thursday, January 9th.

1. The title of our outlook was "It's Not Really Complicated". As we reflect upon 2019 and contemplate 2020, we would never deny the market is a complex beast, yet we find it incredible how consistent the market has acted relative to history.

2. As anyone who reads our commentaries knows, a year ago we were optimistic on 2019 as we viewed it as "a post-pause year". 2012, the year after the 2011 pause, and 2016, the year after the 2015 pause, were very good years for the stock market. We believed 2019 would be consistent with those years. That turned out to be the correct call.

   Sadly, as happened in 2012 and 2016, investors reacted to the drawdowns of the previous years by selling equities into a rising market. Classic recency bias. Since 1984 there have only been 9 years of net outflows from equities[3], and these were two of them. Count 2019 as yet another. Over that same time period, the year after a net outflow year has always been positive for the S&P 500 as investors capitulate and come back into the market. Call it "the second year after a pause year". 2013 and 2017 were great years for returns as investors poured money back into the market. We think 2020 will see a similar dynamic.

3. We see the economy becoming too hot as the biggest risk for equities. We do not agree with the thesis that earnings will disappoint. After a year of lackluster year-over-year earnings, the bar will be low and thus easy to achieve good numbers. The combination of a President who wants a hot economy going into an election, the Fed pumping liquidity, reduced China trade uncertainty, USMCA, and the wealth effect of a good stock market suggests to us that the surprise could be to the upside. In response to a potential hot economy, we worry the Fed might have to adjust policy in 2021. While we doubt it would impact returns in 2020, it could handicap returns down the road.

C. Our 2020 portfolio positioning will obviously evolve according to how the market reacts. Flexibility is one of the benefits of a style-unconstrained strategy.

   Let me begin by discussing how our portfolios are positioned today prior to sharing what we suspect might happen:

REGIONAL AND STYLE ALLOCATION:

1. ASIA EX-JAPAN

We maintain this as our favorite region as we see investors gradually re-entering these markets. We like the growth names here, as they are valued at substantial discounts to their US counterparts.

2. EUROPE

We are not believers that Europe will outperform the US in 2020. Since Europe is heavy in cyclicals, that bullish argument is predicated on European economies experiencing meaningful acceleration. We do not buy that argument. "Cheapness" without a catalyst is not a reason to invest.

Having said that, there are a number of European companies we really like. But they sell products globally and are not dependent on the European recovery thesis.

3. JAPAN

Our global strategies are materially underweight Japanese stocks, as we are not buyers of the "Japan is turning" thesis (which has been a bullish argument from many for years). Any time someone presents that argument, ask what individual names they own BIG in their personal portfolios. We struggle to find ideas compelling enough to warrant a meaningful slice of concentrated portfolios.

4. US

Seems to us the most consensus call is that international is going to outperform the US. We question that, as we think 2020 is going to surprise on the upside. The only region we suspect will do better than the US is Asia ex-Japan.

As we said, we consider ourselves a manager that invests in value opportunistically. Value outperformed in the second half of 2019, and we do think value will continue to do well into 2020. However, we suspect its outperformance will begin to wane sometime later in 2020. While value became cheap last year and is correcting back to normalized valuation, it did NOT get to full-blown recessionary cheapness which ultimately is the really fat pitch.

Many of the uber-growth names were decimated in the second half of last year. Therefore, we do not believe we should necessarily sell growth for value at this time.

However, we do believe the defensives will continue to underperform. Ultimately, as investors chase back into the market, they tend to become greedy and put their dollars into what they think will make them money, not what they think will lose them less.

5. WHAT COULD HAPPEN?

Again, we will let the market dictate how our portfolios should be positioned. We suspect that as risk appetite increases this year, the defensives will get cheaper. That would allow us to build defensiveness into the portfolios later in the year, in anticipation that 2021 might be a tougher year for equities than 2020.

Time will tell and, as always, we will remain flexible.

We appreciate the business you have given us. Without your vote of confidence, we would not exist. Many thanks.

Andrew

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[1] Market as defined by the S&P 500.
[2] Factset, July 28, 1995 through December 31, 2019.
[3] ICI, Bloomberg.