WINDROSE ADVISORS

2020 ANNUAL REVIEW AND 2021 OUTLOOK

SUMMARY

Most investors are still bewildered that the pandemic shock that rocked the world in 2020 led to a jaw-dropping rally in financial markets that brought equity indices to new highs.

The answer, of course, is the unprecedented succession of monetary and fiscal stimulus measures worldwide, which took the cost of money to near zero and boosted the appeal of longer duration assets (figure 1).

For the year, global equities gained 16.3% and U.S. fixed income rose by 7.5%, while broad commodities declined by 3.1%, amid declining market volatility and a weaker U.S. Dollar.

REVIEW OF 2020

No one could have anticipated the events of this year and we were no different than most market observers in our expectation of a continued economic expansion in our 2020 outlook. Yet the adverse market outcome served once again to prove the value of a diversified portfolio to navigate market upheaval, and to validate the adage that time in the markets is more important than timing the markets. Resisting the urge to move to cash at the darkest hour of the crisis, our clients were well rewarded by the subsequent market recovery. Our own advice to take measured market risk by overweighting directional hedge funds relative to global equities was most satisfying as our mix of funds delivered almost twice the returns of global equity markets.

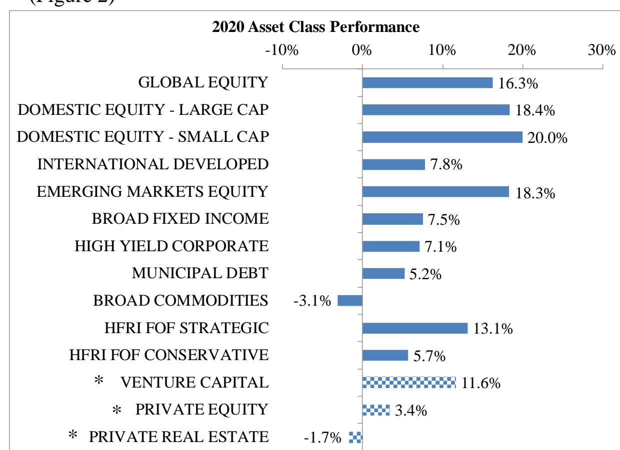
(Figure 1)

Defensive investments helped mitigate the downturn in March and led the rally in the second quarter. U.S. equities outperformed international equities, growth sectors outperformed cyclical sectors, gold outperformed energy and even treasuries outperformed higher risk fixed income investments.

As the summer drew to a close a rotation away from these particular investments began. By September, the anticipation of COVID-19 vaccines and uncertainty surrounding the U.S. presidential election took center stage, leading investors to ponder a rotation toward beaten-down cyclical areas of the market more geared to an economic recovery. In November, the back to back announcements of the Pfizer-BioNtech vaccine and democratic victory in the U.S. presidential election unleashed animal spirits and new market gains.

Reflecting the market recovery, equity volatility (VIX index) declined from the peak of 82.7 on March 16th to 22.8 by year-end. The yield on the benchmark 10-year U.S. Treasury note rose from a calendar year low of 0.51% in August to 0.92% by December. Spurred by low interest rates, the U.S. currency has declined by 12.5% since March 20th (DXY U.S. Dollar index). Year-to-date, commodities and real estate were the only broad asset classes to deliver negative returns (figure 2).

(Figure 2)



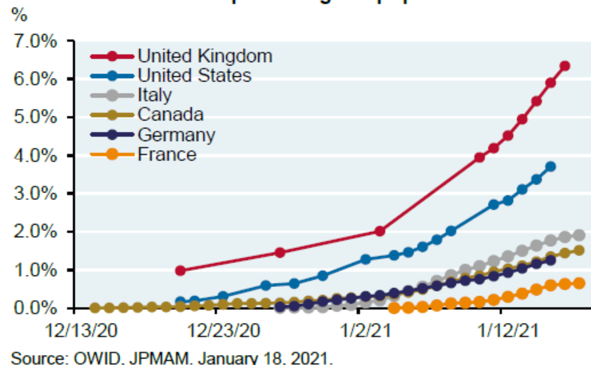
Source: Bloomberg

*(*Venture Capital, Private Equity and Private Real Estate report with a lag. We show the performance of the most recent reported year through June 2020).*

ROARING 20s?

Between 1918 and 1920, in the aftermath of the first World War, the world was ravaged by a deadly flu pandemic. The subsequent recovery saw an unprecedented expansion in consumption and economic growth, earning the decade the nickname of "roaring 20's." Almost a century later, the onset of COVID-19 is drawing parallels as multiple vaccines are progressively deployed (figure 3) and the world turns its attention to a post-pandemic recovery.

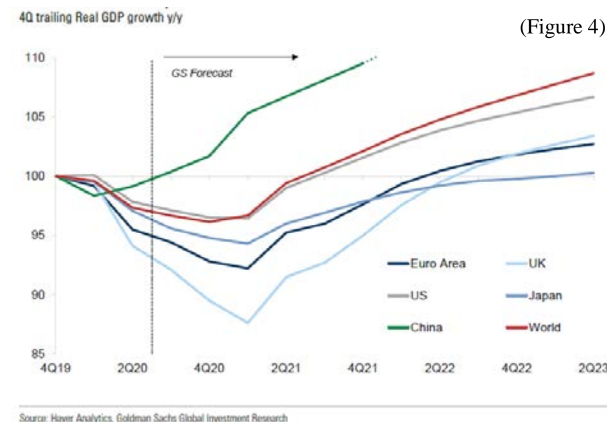
(Figure 3)



Source: JP Morgan

With low inflation and significant economic slack, the Fed is expected to maintain a low interest rate policy for the next 2-3 years. And the advent of a full democratic sweep, following the results of run-off senate elections in Georgia this January increases the likelihood of more significant fiscal stimulus in 2021. Thus, the era of permanent economic support appears unlikely to wane near term, supporting the prospect of a sustained recovery throughout 2021 (figure 4).

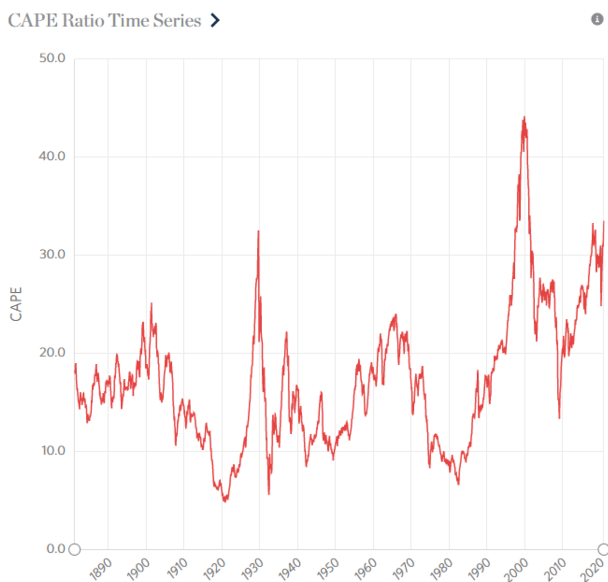
(Figure 4)



Source: Goldman Sachs

However, a more positive economic backdrop may not necessarily yield strong market returns in the coming decade. As a result of renewed stimulus, U.S. equities and bonds now trade at extreme valuations again. Relative to history, U.S. equities are expensive, trading at levels similar to 1929, according to the Cyclically Adjusted PE ratio (or CAPE ratio, figure 5).

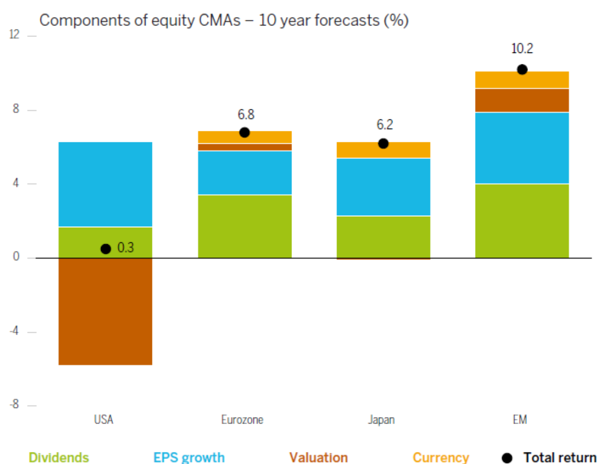
(Figure 5)



Source: Research Affiliates

Therefore, any assumption of mean-reversion of equity valuations toward a long term average implies a compression in prospective returns, offsetting higher U.S. earnings growth (figure 6).

(Figure 6)

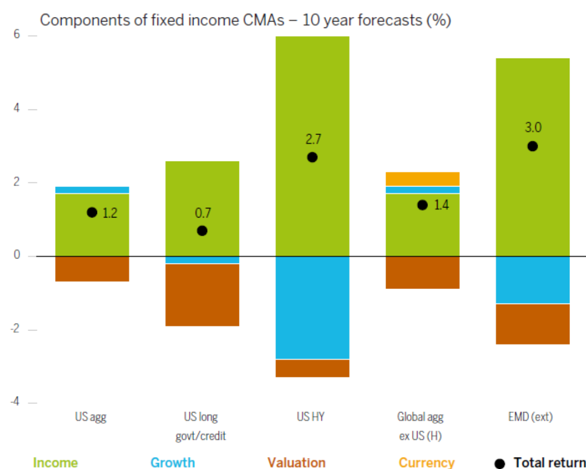


Source: Wellington Management

By comparison, lower earnings growth in foreign countries is already reflected in average valuations, yielding higher long term prospective returns overseas.

Prospective returns are not much higher in fixed income markets given low starting yields, low credit spreads and flat yield curves (figure 7).

(Figure 7)



Source: Wellington Management

Low yields on cash and bonds are leading investors to favor equities – the TINA effect, or "There Is No Alternative" to stocks – which could sustain high equity valuations in an era of constant government support. However, even if one assumes no mean reversion, prospective returns look paltry. Earnings growth and dividends on U.S. stocks are expected to return about 6.0% over the next decade. Coupled with a yield of 1.1% at year-end on the Barclays U.S. Aggregate Index, a traditional 60/40 stock/bond portfolio would be expected to deliver only 4.0%, leaving essentially no returns to individual investors after taxes and inflation (assuming the Fed's 2% target), and a far cry from the 7% or so commonly sought by institutions.

Unfortunately, investors should fear a decade of low prospective returns from a traditional portfolio (long secular growth and high carry fixed income): the "*boring 20s*" may become a more apt moniker.

Fortunately, we think that investors can take action to avoid this fate and adopt a playbook for recovery in an expensive market.

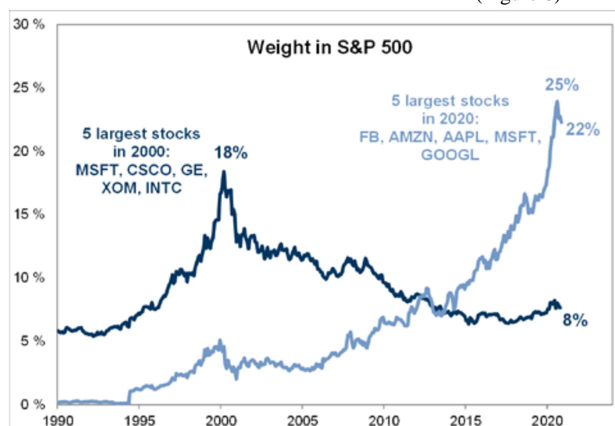
PLAYBOOK FOR RECOVERY

Fans of T*he Queen's Gambit* show could marvel at the main protagonist's ability to anticipate her opponent's moves, charting a course to victory in a chess competition. The economic machine, however, is more complex than the game of chess, and might share more similarities with the game of poker, forcing a player to consider the odds of success of a particular hand. Today, the market extremes are so wide that simply tilting one's portfolio away from these extremes greatly improves the odds of success.

1. Favor actively managed funds:

While broad indices appear set to deliver unpalatable returns, consider for a moment how skewed they are to a particular set of stocks. By the end of 2020, the five largest stocks in the S&P500 (all in related sectors) represented 25% of the index, a historical high (Figure 8).

(Figure 8)

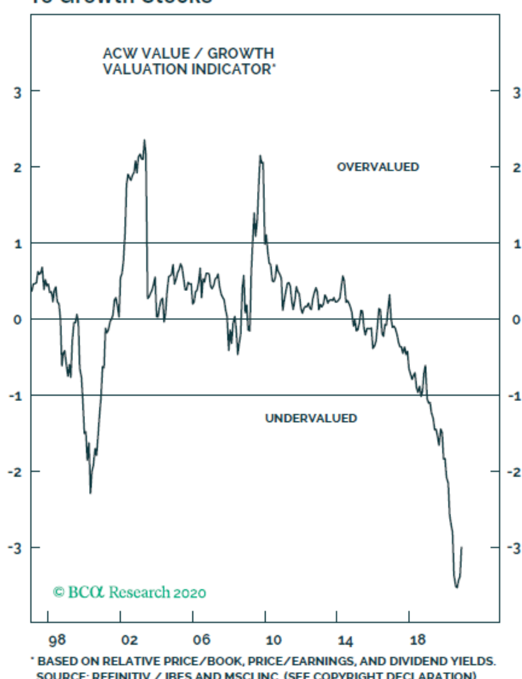


Source: Goldman Sachs

For the index's outperformance to continue, one needs to assume that this small group of large cap technology stocks will represent an ever growing share of the index. However, rising interest rates (hurting long duration assets like technology stocks), anti-trust actions, regulation and taxation (which are more likely with a democratic administration) and the risk of disappointing growth (demand has been pulled forward by the pandemic, and market penetration is high) could all disrupt established assumptions and lead to ho-hum returns as opposed to the market beating performance we have been accustomed to.

Conversely, active managers that focus on company fundamentals and stock selection rather than benchmark weights will be increasingly rewarded as dispersion in performance rises among stocks and market leadership moves away from mega-cap names. Implied biases of most active managers tend to favor value and smaller capitalization stocks. As shown in figure 9, value stocks are now extremely cheap (three standard deviations from the norm) and will tend to benefit from any cyclical improvement in the global economy.

(Figure 9)



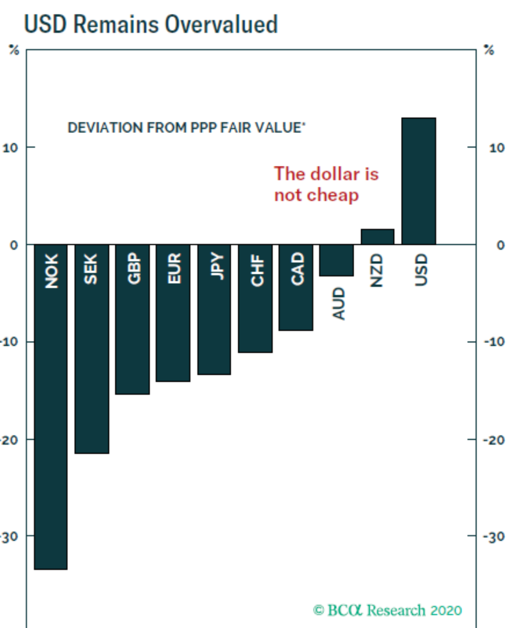
Source: BCA Research

Along the same lines, smaller capitalization companies typically have weaker balance sheets that exposes them to higher risk of failure in recessions. Conversely, they tend to rebound in a recovery when the risk of bankruptcy fades away, as we experienced in the fourth quarter of 2020. The era of permanent government support is now setting up strong secular tailwinds for smaller capitalization stocks in coming years. In addition, active managers are adept at identifying promising innovators with more room to grow than their large cap brethren and these less well covered companies offer better opportunities for mispricings.

2. Favor non-US assets:

The U.S. Dollar is a counter-cyclical currency that acts as a safe-haven and tends to appreciate at times of crisis. The reverse is true in a recovery as risk appetites return and investors seek higher-yielding opportunities in other markets. Having appreciated relative to other world currencies through March 2020, the U.S. Dollar remains overvalued (figure 10) but has since started to weaken.

(Figure 10)

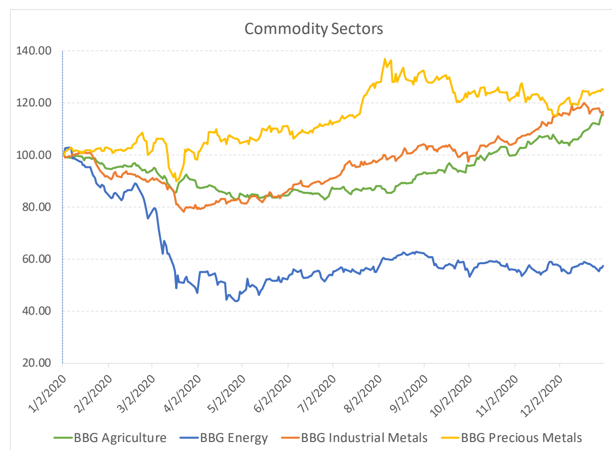


Source: BCA Research

Currency weakness is a consequence of monetary stimulus and resulting low interest rates. With no change in policy on the horizon, a secular trend is in place that will provide a tailwind for U.S. investors to all assets denominated in foreign currencies. Emerging markets in particular stand to benefit from a triple whammy of re-acceleration of global growth, currency appreciation and revaluation back to historical average.

Commodities are mainly traded in U.S. Dollar and will also benefit long-term from the rising purchasing power of foreign nations. The fact is, despite the negative headline index, most commodities have already started to rally and were up for 2020, with energy the main detractor. Ex-energy, the Bloomberg Commodity Index would have been up 15.2% for the year (figure 11).

(Figure 11)



Source: Bloomberg

3. Favor alternative assets:

Bonds now offer low yields and asymmetric risks, and their value as a dampener of equity risk in diversified portfolios has declined. In addition, they have lost their appeal as a source of income for conservative investors. Alternative assets provide a partial solution to portfolio diversification by expanding the opportunity set into illiquid markets and by allowing more opportunistic investing across a variety of strategies.

For investors with significant assets and long time horizons, private investing typically allows the capture of an "illiquidity premium." In addition, market inefficiencies can develop which are well suited to private markets. One such example arose in 2020 with private credit. As banks shied away from providing credit to cash-strapped corporations, private credit funds stepped in to provide funding at attractive rates for investors and with better covenants than most recently issued loans. Windrose Advisors participated in the opportunity through our partner funds, and by creating a co-investment structure offering access at lower cost to our clients.

Within alternative investments, hedge funds are often dismissed as they failed to keep up with equity indices over the past decade. It is important to note that hedge funds are simply an investment structure that encompasses a wide variety of strategies, some designed to capture equity upside, and some meant to protect against market volatility.

Taken as a whole, "hedge funds" (as proxied by the HFRI Fund Weighted Index) tend to deliver returns between equity and fixed income. However, equity-oriented strategies can indeed outperform the equity index: in 2020, technology and health care sector focused funds handily beat the S&P500 index (figure 12).

(Figure 12)	1yr	20yr
HFRI Sector Tech/Health	27.3%	7.50%
S&P500	18.4%	7.46%
HFRI Fund Weighted Index	11.6%	5.54%
BC US Aggregate	7.5%	4.83%

Source: Bloomberg

Portfolio construction matters in alternatives, and significant exposure to equity sector funds contributed to our directional hedge funds portfolio outpacing the market in the past year. Of course, manager selection matters too, as the five tech/health sector funds in our directional hedge fund portfolio delivered about twice the returns of the HFRI sector index on average.

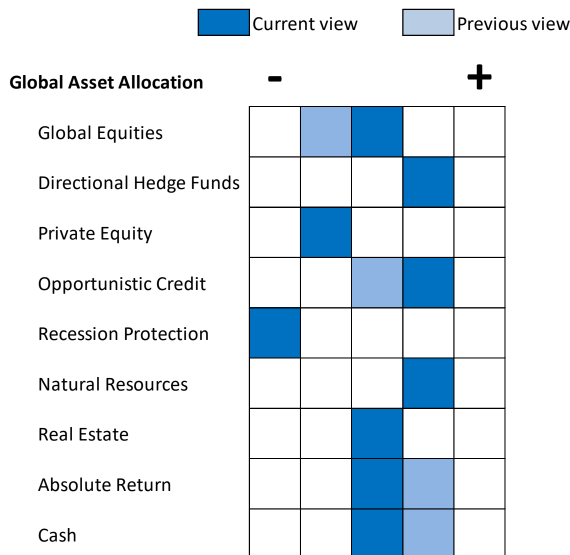
Much of the benefits of alternative investing are predicated on accessing top teams in a complex market. At Windrose Advisors, we feel fortunate that years of building our team, network and infrastructure are now bearing fruit at a time when alternative investing is becoming more important than ever to build and preserve wealth.

2021 OUTLOOK

As we write this letter, the inauguration of President Joe Biden has taken place, restoring some order and normalcy after a chaotic start to the new year that saw a mob of extremists storm the U.S. Capitol in a vain attempt to overturn election results. In the end, the democratic institutions of the U.S. have prevailed, and the market is now looking past the unrest to the end of the pandemic and the longer term implications of a Democratic government.

Near term, ebullient market conditions and delays in the vaccine rollout create the potential for a correction. However, the long term outlook is bullish for equity assets given the amount of liquidity being pushed into markets. Monetary and fiscal authorities seem willing to maintain support well into a recovery, an environment that most of us have not experienced in our careers and that portends higher risk of future inflation. Should inflation fears materialize, we think that a bond market sell-off could occur at the long end of the yield curve and we plan to cut duration exposure.

For now, the availability of vaccines and resolution of the U.S. presidential election provided the catalysts for us to move our view of Global Equities back to neutral. We expect that our emphasis on active management and alternative assets will help us navigate frothy markets. We remain bearish on recession protection assets given low yields and the risk of rising rates and view private Opportunistic Credit as a good complement to portfolios, trading some liquidity for secured income.



2020 was a year of anguish amid fears of infection and economic dislocation. Quarantined at home, many of us indulged in additional screen time with our favorite shows to provide a mental outlet and fight boredom. If last year felt like we were stuck in *Schitt's Creek,* here is hoping that 2021 leaves us feeling like we are moving to *The Good Place*.

INDEX KEY

Indexes are unmanaged, statistical composites and their returns do not reflect payment of any brokerage commissions or fees an investor would pay to purchase the securities they represent. Such costs would lower performance. It is not possible to invest directly in an index. The indexes include a different number of securities and have different risk characteristics than the model. Past performance of the indexes and benchmark is no indication of future returns.

Global Equity (MSCI All Country World-USD), Domestic Equity Large Cap (S&P500), Domestic Equity Small Cap (Russell 2000), International Developed Equity (MSCI EAFE), Emerging Market Equity (MSCI EM), Energy Equity (MSCI ACWI Energy) Broad Fixed Income (Barclays Aggregate), U.S. Government Debt (Barclays U.S. Treasury), U.S. Inflation-linked (Barclays U.S. Treasury Inflation Notes), U.S. Corporate Debt (Barclays U.S. Corporate), U.S. Securitized Debt (Barclays U.S. Securitized), Emerging Debt U.S. Dollar (JP Morgan Emerging Market Bond Index Global), Emerging Debt local currency (JP Morgan Global Bond Index Emerging Markets), High Yield Debt (Barclays U.S. High Yield), Municipal High Yield (Barclays U.S. Municipal High Yield), Municipal Debt (Barclays U.S. Municipal), Commodities (Bloomberg Commodity Index), Public Real Estate (MSCI U.S. REIT), Global Hedge Funds (HFRI Fund Weighted Composite), Directional Hedge Funds (HFRI Fund of Funds Strategic), Absolute Return Hedge Funds (HFRI Fund of Funds Conservative), Venture Capital (Cambridge Associates Venture Capital Index), Private Equity (Cambridge Associates Private Equity Index), Private Real Estate (Cambridge Associates Private Real Estate).

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