

From: Aequitas Investment Advisors

Re: **A Nation on Edge – Challenges and Opportunities Ahead!**

As we all know, our capital was besieged on January 6th by those protesting the results of the presidential election. Of the tens of thousands of protestors, an angry mob of several hundred extremists broke into the capital building wreaking havoc and threatening the lives of legislators and even the Vice President. At least five lives were needlessly lost, and more than 80 arrests have been made so far. What has traditionally been a peaceful and orderly transfer of power from one administration to the next has turned out to be chaotic and marred by violence. With some bipartisan support, the President has been impeached a second time with a charge of “incitement of insurrection” for his role in the protests on January 6th. There will be at least 25,000 National Guard troops in our nation’s capital to secure the inauguration given the threat of more violence by extremists (that is more than five times the number troops in Washington than in Afghanistan and Iraq combined!). The President’s persistence in fanning the flames has encouraged extremist elements among his supporters, upended the foundation of our democratic process and severely tarnished our reputation as the shining beacon of democracy around the world.



How this will all turn out is unclear, but what we do know is that on January 20th we will have a new administration charged with the

responsibility of calming the nation, finishing the fight against the pandemic, and helping restore the livelihoods to those who have been hardest hit by the economic downturn. These challenges may seem insurmountable, but with a new economic team at the helm combined with an undivided Congress, there is new sense of possibility and an opportunity to enact a bold economic stimulus plan designed to get us through the challenges of the pandemic more quickly and fully reopen the economy as soon as safely possible.

Good Riddance 2020

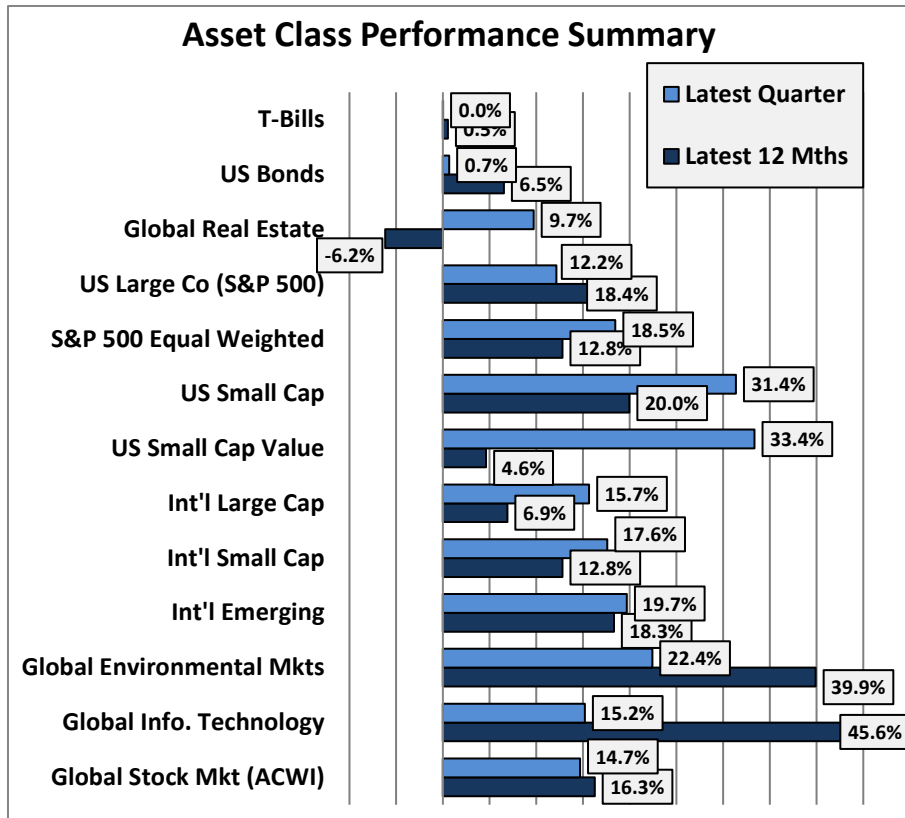
When writing our fourth quarter letter each January, we customarily begin with a review of major events of the previous year, but rather than rehashing the abysmal events of 2020, we will focus instead on identifying some of the major challenges and opportunities we face as we look toward the future. Despite the immediate state of affairs in our nation, there are some good reasons to be guardedly optimistic about 2021, however, any such optimism depends on our winning the fight against Covid-19 as quickly as possible.

The Critical Element: Vaccine Rollout

With so much riding on the vaccine rollout, the early news on that score is sadly disappointing. Early last December, the White House Coronavirus Task Force predicted that 20 million people would have been vaccinated in the U.S. by the end of 2020, but we fell well



short of that goal; even after the first two weeks of January, only about 14 million doses have been administered. The delay appears to be due to a lack of coordination and poor communication between the federal and state governments as well as Centers for Disease Control guidance which may have been interpreted too strictly. Task force member Dr. Anthony Fauci recently stated that implementation adjustments are being made and he expects to see an acceleration of the rollout in the coming weeks. Furthermore, several new vaccines (Johnson & Johnson and AstraZeneca) may soon be approved for emergency use and Fauci believes that by early spring we should be in “open season” for the vaccine (i.e., available to anyone who wants it). And if “everything goes right,” Fauci believes that by the end of October there is the potential for between 70% to 85% of the U.S. population to be vaccinated at which point we may reach herd immunity which is a necessary condition for our lives to return to a true sense of normalcy.



Asset Class Performance Review

The year of 2020 ended up being surprisingly strong for both the bond and stock markets. Due to plummeting interest rates engineered by the Federal Reserve, U.S. Bonds gained 6.5% for the year and stocks around the globe gained just over 16%. U.S. Large Cap Stocks, as measured by the S&P 500 Index, gained 18.4%; however, the Index is market-cap weighted which means that the five largest components in the Index (i.e., Apple, Amazon, Facebook, Google and Microsoft) disproportionately drove the Index's performance. When equally weighting the 500 stocks within the Index, which is a more accurate measure of the *average* stock's performance, the rate of return for the year was 12.8%. Nonetheless, these are remarkable returns, especially during a pandemic-driven economic downturn!

In looking at the trailing 12-month performance among the other asset classes, the only negative return, unsurprisingly, was Global Real Estate (-6.2%) which reflects the sharp drop off in activity within commercial real estate structures. The

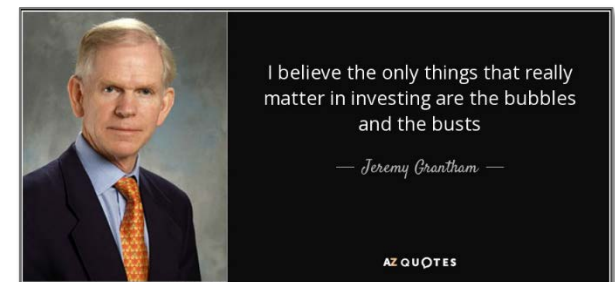
best returns came from Global Information Technology (+45.6%), which benefited from the technology boom during the pandemic, followed by Global Environmental Markets (+39.9%), which benefited from the growing concern about the environment and the climate crisis. Next in line were U.S. Small Caps (+20.0%), Int'l Emerging Markets (+18.3%), Int'l Small Caps (+12.8%), Int'l Large Caps (+6.9%). We added a new asset class to the summary, U.S. Small Cap Value (+4.6%), to point out that while it was one of the lagging asset classes for the year, it posted the best gain for the most recent quarter (+33.4%). We anticipate seeing other lagging asset classes picking up steam as the economic recovery unfolds.

For the latest quarter, the returns were positive across the board; the exception being T-Bills which were flat (T-Bills are a proxy for cash). U.S. Bonds eked out a gain of 0.7%. All of the stock market asset classes in our analysis posted robust positive returns ranging from 9.7% (Global Real Estate) to 33.4% (U.S. Small Cap Value). The all-encompassing Global Stock Market gained 14.7% for the quarter.

Two Perspectives Looking Forward: The Realistic Pessimist vs. The Perpetual Optimist

When attempting to assess how the investment markets might behave as we look toward the future, we have found it helpful to consider the outlooks of a few tried and true investment strategists. Two of the most successful such prognosticators are Jeremy Grantham and Jeremy Seigel who have provided helpful insights to our firm since our founding thirty years ago. Their outlooks appear sharply contrasting this year, yet we find compelling rationale in both perspectives.

Jeremy Grantham, legendary investor and co-founder of the Boston-based asset management firm, Grantham, Mayo and van Otterloo & Co. LLC (GMO), gained fame by accurately predicting three market bubbles: Japan's stock bubble in 1989, the technology stock bubble in 2000 and the housing bubble in 2007. However, getting the precise timing down has not necessarily been Grantham's forte. For example, in 1998 he warned his investors about the technology stock bubble about two years before it burst which caused GMO to lose some of its clients who

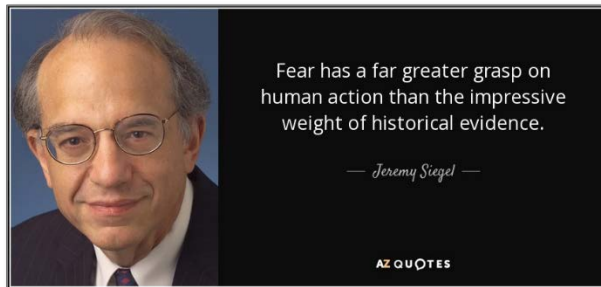


grew impatient as technology stocks continued to soar (i.e., fear of missing out). In the end, however, despite his early call, GMO's faithful clients reaped the rewards of his advice. Perhaps Grantham is early, once again, with his warning of another bubble in the U.S. stock market, but he recently offered the following counsel to fellow professional asset managers in his January Viewpoint letter:

As often happens at bubbly peaks like 1929, 2000, and the Nifty Fifty of 1972 (a second-tier bubble in the company of champions), today's market features extreme disparities in value by asset class, sector, and company. Those at the very cheap end include traditional value stocks all over the world, relative to growth stocks. Value stocks have had their worst-ever relative decade ending December 2019, followed by the worst-ever year in 2020, with spreads between Growth and Value performance averaging between 20 and 30 percentage points for the single year! Similarly, Emerging Market equities are at 1 of their 3, more or less co-equal, relative lows against the U.S. of the last 50 years. Not surprisingly, we believe it is in the overlap of these two ideas, Value and Emerging, that your relative bets should go, along with the greatest avoidance of U.S. Growth stocks that your career and business risk will allow.

We generally agree with Grantham's assessment and have expressed many of the same concerns for the past few years which has caused us great consternation as we have seen Value and Emerging Markets stocks significantly underperform the broad market indices (except for the past nine months, fortunately). As you may recall from recent review meetings, the core elements of our portfolios are tilted toward Value stocks in the U.S., and other Developed Markets, and we have maintained an overweight toward stocks in the Emerging Markets. We believe this strategy will prove beneficial in the coming years.

Moving on to the next Jeremy, Jeremy Siegel is Professor of Finance at the Wharton School and author of several best-selling books, including *Stocks for the Long Run*. He has earned the reputation of being perpetually bullish toward the stock market which has proven to be a successful strategy *over the long run*. In contrast to Grantham, his outlook for 2021 is rather optimistic, albeit with a few caveats.



- Siegel believes the market will end up 10% to 15% higher by the end of the year, but not without a short-term setback (i.e., a stock market correction of 5% to 10%).
- While Siegel is a fiscal conservative, he understands that the economy needs a massive shot of additional stimulus to help lift us out of the challenges caused by the pandemic. He believes the positive benefit of directing more stimulus toward the lower and middle-income workers will more than offset the inevitable negative impact of higher taxes.
- Siegel's optimistic outlook for stocks also factors in the massive amount of monetary stimulus provided by the Federal Reserve, i.e., low interest rates, which makes stocks significantly more attractive than bonds (as long as interest rates remain low or only slightly higher than current levels).
- Siegel cites the rollout of Covid-19 vaccines as a critical element in his optimistic forecast, but he also sees President-elect Biden's infrastructure spending plans as an integral component of the recovery.
- As for U.S. stocks, Siegel is concerned about the composition of the S&P 500 Index which has a disproportionate weighting toward high-priced Growth Stocks and very high-priced technology stocks (on this point, he shares some of Grantham's concern). Siegel prefers stocks with lower price-to-earnings ratios and those with favorable dividend yields which are more characteristic of Value stocks.

While we dare not predict a 10% to 15% return on stocks by the end of the year, we do share Siegel's optimistic view that the additional fiscal stimulus, low interest rates and the presumed successful introduction of vaccines over the next six-plus months will prove highly supportive of a strong economic recovery in the second half of the year. The caveat, of course, is the assumption that vaccines will be available and administered as quickly as possible (and that we do our best to contain the pandemic between now and then).

How Do We Deal with A Possible Stock Market Bubble?

If the U.S. stock market is in a bubble as Jeremy Grantham argues, how do we address this risk in a practical manner without attempting to time the market? There are several time-tested strategies we believe will prove beneficial, including maintaining a balanced portfolio structure, significantly underweighting the highest-priced asset classes and maintaining a high degree of global diversification.

Clients who have been with us through both bull and bear markets have probably come to appreciate our balanced and relatively conservative approach to investing. We have always believed the goal of investing is to help our clients achieve their financial goals with an appropriate level of risk, i.e., taking no more risk than is necessary to achieve the expected rate of return. Since our founding in 1991, we have maintained a fundamentally optimistic view about stock market returns *over the long term*, yet we have also been mindful that unexpected events often occur (2020 anyone?) which is why one of our highest priorities is to allocate a significant portion of the portfolio to low-risk assets in case the pessimists are right. As a reminder, some of the most important components of our approach include:

- Having a sufficient allocation to high-quality bonds in order to dampen volatility and to provide a fail-safe section of the portfolio to protect against stocks market downturns and to provide for our clients' financial needs. By building portfolios upon this essential foundation, we can avoid having to sell stocks at depressed prices; rather, we can be buyers instead when prices are low.
- Underweighting stocks with unsustainably high prices in favor of more reasonably priced stocks of profitable companies. Grantham's bubble concern is primarily focused on U.S. Growth stocks, the largest five being Apple, Amazon, Microsoft, Google and Facebook. Portfolio risk can be reduced by underweighting such Growth stocks and overweighting asset classes which look more reasonably priced, including Value stocks and Emerging Markets stocks (that same strategy worked very well for more than a decade following the bursting of the technology stock bubble in 2000).

Long-Term Implications of Extremely High Stock Prices

Past experience with stock market bubbles, including the tech bubble in the U.S. (1995-2000) which we'll examine further, indicates that *subsequent* long-term returns for asset classes which have reached unsustainably high price levels can be particularly poor for extended periods of time. We believe we are in this situation today following the extraordinary returns for U.S. Large Cap stocks over the past ten years.

At the peak of the U.S. tech bubble in 2000, technology stocks comprised about 65% of the NASDAQ Index. The Index had soared by more than 500% from the beginning of the bubble's formation in early 1995 to its peak in March of 2000 at which point the Index was trading for an astronomical Price-to-Earnings Ratio of

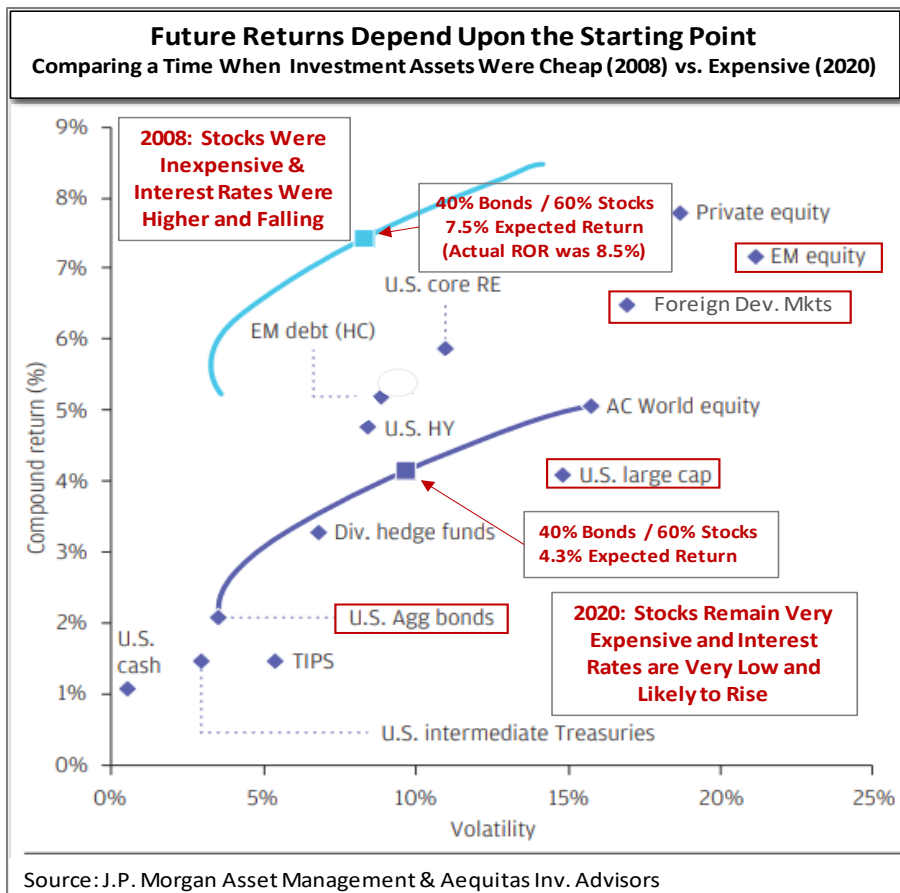
73x (today it is trading for about 35x). From that peak of *irrational exuberance*, the NASDAQ crashed by more than 70% between March of 2000 and September of 2002. From there, it took another 12 years for the NASDAQ Index to return to its March of 2000 price level, i.e., the NASDAQ's cumulative return was negative between March of 2000 and February of 2015. The situation was a little better for stocks in the S&P 500 Index which also reached unsustainably high price levels in August of 2000 when the Index was trading at a P/E Ratio of about 35x (about double its long-term average of about 16x; today it is trading for about 23x which is the highest level in more than twenty years). From its bubbly peak, the S&P 500 Index fell by 45% between August of 2000 and September of 2002 from which point it took another four years to return to its August of 2000 price level, i.e., the S&P 500's return was negative for more than six years from March 2000 to October of 2006.

Fortunately for diversified investors, while stocks in the S&P 500 Index were falling and correcting from unsustainably high price levels, other more reasonably priced asset classes performed quite well. For example, compared to the S&P 500's negative return between March 2000 to October 2006, during the same period, the average annual return for U.S. Small Cap Value stocks was 16.7% and 13.5% for U.S. Large Value stocks – an astounding difference!

Of course, the past four years has been a different story with the S&P 500 and Growth Stocks outperforming U.S. Small Value and U.S. Large Value stocks by a wide margin. Nonetheless, we believe that Value stocks today, as well as many non-U.S. stock asset classes, are much more favorably priced than the market-cap weighted S&P 500 Index and we expect they may offer higher returns over the next ten years.

Expected Future Returns

In the chart at the top of the next page, J.P. Morgan plotted 10-year future rate of return estimates and risk levels for various bond and stock asset classes (the expectation being that the more risk, or volatility, one is willing to accept, the higher the return one should expect over the long-term). The two lines represent combinations of asset classes at two starkly different points in time: (1) December 2008 near the bottom of the Great Recession when stock prices were very low and bond interest rates were somewhat high and (2) today (as of December 2020) when stock prices, especially U.S. Large Caps, are high and interest rates are historically low. At the end of 2008, the "expected" return for a 40% Bond and 60% Stock portfolio for the following 10-year period was 7.5% (a combination of a 5.25% for bonds and 9.0% for globally allocated stocks). The *actual* return



for that 40-60 portfolio was 8.5% for the 10-year period following December of 2008. Today, expected returns over the next ten years are significantly lower given that stocks are expensive, unlike 2008, and interest rates are at very low levels. The expected return for the same 40% Bond and 60% Stock mix over the *next ten years* is just 4.3% (a combination of an expected return of just about 2% for bonds and about 6% for globally diversified stocks). The expected return for the S&P 500 is slightly under 4% at a much higher level of risk than that of the 40% Bond and 60% Stock balanced portfolio. These estimated future returns are consistent with several other economists we track as well as our own research.

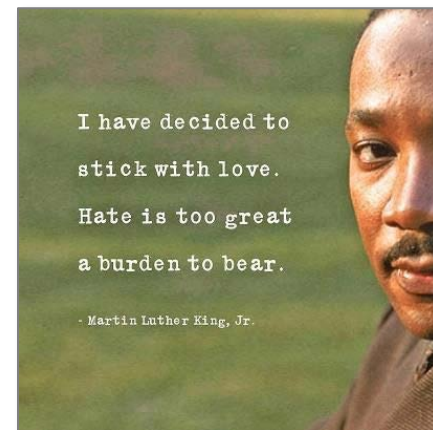
Our View: Guarded Optimism

As mentioned at the opening of our letter, there are reasons to be optimistic about 2021 given the renewed battle against the pandemic and the proposed \$1.9 trillion

economic stimulus plan announced by the Biden administration. However, with the U.S. stock market being generally expensive, and with Growth Stocks arguably in bubble territory, we believe this is particularly important time to weight portfolios toward asset classes which are more reasonably priced, and which offer the potential for superior capital appreciation. Further, it is also important to maintain a balanced portfolio structure with high-quality short-term bonds as a safe haven to reduce risk and provide liquidity for cash flow needs and/or rebalancing. Important lessons have been learned from the past and this is not the time to forget them.

Closing Thought

We've seen too much hatred and division in the recent weeks and months and we find our country deeply divided. Yet, there have been other times in our history when hatred and violence were prevalent, particularly in the 1960's. At that time, our country was torn apart by anti-Vietnam War protesters and deep racial divisions which led to what some believe was the greatest wave of social unrest our country had experienced since the Civil War. Following the assassination of Martin Luther King, Jr. in April of 1968, riots occurred in more than 100 cities across the country and many lives were lost. As the third Monday of this month honors the life of Martin Luther King, Jr., we'll close with excerpts from his essay entitled, *I Have Decided to Stick With Love*, which seems as appropriate today as when the words were written more than fifty years ago:



“I’m concerned about a better world. I’m concerned about justice; I’m concerned about brotherhood and sisterhood; I’m concerned about the truth. And when one is concerned about that, he can never advocate violence.”

“And I say to you, I have also decided to stick with love, for I know that love is ultimately the only answer to humankind’s problems. And I’m going to talk about it everywhere I go. I know it isn’t popular to talk about it in some circles today. And I’m not talking about emotional bosh when I talk about love; I’m talking about a strong, demanding love. For I have seen too much hate. [...] and I say to myself that hate is too great a burden to bear.”