BIECHELE ROYCE ADVISORS

4th Quarter 2020

What an extraordinary and difficult year it has been. Extraordinary in terms of the market moves that occurred in 2020, and certainly difficult in terms of the human toll of sickness and death. The global pandemic caused the economy to grind to a halt early in the year and financial markets collapsed sharply in February and March. That period witnessed the fastest ever 30%+ decline from a record high. What happened to markets since March is one for the history books. If we would have told you back then that the year would end solidly in positive territory while the pandemic was still raging, and the country became even more deeply divided politically no one would have believed it. As devastating as the human toll of the pandemic has been, the resiliency of our markets, economy, democracy and the extraordinary achievements of the scientific and medical communities is nothing short of amazing. While there will certainly be some dark days of winter ahead, we are encouraged by the light we see at the end of the tunnel.

Here are the percentage gains for the major averages for 2020:

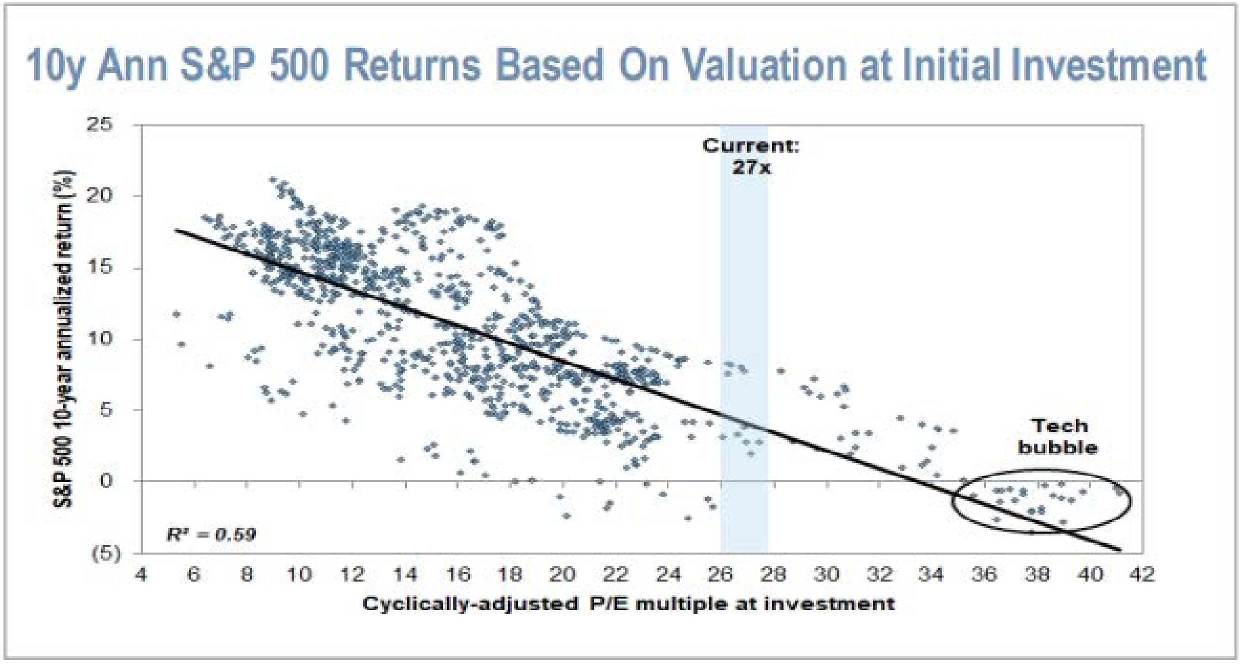
Dow Jones Industrials +7.25%; S&P 500 +16.26%; Russell 2000 +18.36%; MSCI EAFE International +5.07%; Barclays Aggregate Bond Index +5%. The big winner for the year was the technology-driven NASDAQ Composite which climbed over 43%.

We wrote in our last review in the 3rd quarter that the market has become highly bifurcated in that there are a handful of high valuation growth companies dominating the index performance while most stocks are trading at lower valuations. This continued into the year end, and according to data from Ned Davis Research, in the latter part of December when the S&P 500 was up nearly 15% for the year, the index would have been up only half that amount if it were not for six stocks driving the cap-weighted index higher. Further data on the disparity of stock returns comes from Bespoke Investment Group, pointing out as of mid-December, the 50 largest S&P 500 stocks were up over 16%, while the 50 smallest stocks were down 0.4% year to date. Finally, stocks with the *highest valuations and lowest dividends* outperformed the stocks with the lowest valuations and highest dividends.

Back to valuations, and what we wrote last quarter:

> **We see the market as highly bifurcated and we are focused on stocks with stronger valuation support and thus improved upside to downside potential over the next 3-5 years. Many of the cyclical, value-oriented names we own trade at wide valuation discounts to the market and have shown good relative outperformance during the periods of high volatility in the concentrated growth/tech names. Over the long run there is a very strong inverse relationship between the starting valuation of an investment and the future investment return. All else equal, the lower the starting valuation the higher the forward return and vice-versa.**

Valuations do matter. You can't always know when they are going to matter again, but history tells us that they will. The chart below is a graphical representation of how starting valuations matter to forward returns over time. The data is from Goldman Sachs (chart courtesy of Neuberger Berman Funds) and is based on October 30, 2020 valuations. (note the current 27x figure in the chart is now over 30x). The downward sloping shape of the line shows that as the PE multiple at time of investment grows larger, the 10-year annualized return for the market goes lower. This should be intuitive and supports the idea that the price you pay should determine the return you can expect- but this can be easily lost in the heat of rising market, when the price you pay doesn't matter because someone is always there to pay more…until they aren't.



Broad equity market valuations are signaling caution in terms of the long run return potential from these current levels. This same valuation data is not a good predictor of what the market will do in the short run, and we are cognizant of this. Interest rates are very low, and inflation is low and stable which are supportive of higher valuations to some extent. Also, the profitability and capital intensity of many of the technology names today are more favorable to higher valuations than the profitless tech names that drove the dot-com bubble of the 1990's. So, while times are different, we want to be conscious of the risks as they are building with this concentration of the index weight in the technology sector.

We will be watching for opportunities in 2021 to add to exposure in areas of the stock market where valuation disparities offer better upside potential relative to the S&P 500 (where we are buying on the leftward side of the line in the previous chart). We have written previously about the Growth versus Value debate, and we remain confident that value stocks remain attractively priced to deliver outsized returns as the economy recovers. Regarding the Value vs Growth debate - it's not so much about the value index performance as a driver for us, but rather the individual stocks and their performance. (Although we do believe that the value factor's underperformance over the last several years will turn and become a tailwind for many stocks in the coming years, just as it has been a drag in the last few years.) But this debate played less of a role for example in our decision to add equity exposure to attractively valued industrial/cyclical names in the spring of 2020. Our analysis concluded to us that these specific businesses were marked down too far and were priced incorrectly for very little future growth- and we saw this as an opportunity to buy great businesses at bargain prices. Under the hood of the Growth vs Value debate is the idea that some businesses, while they are indeed high-quality businesses, may be approaching peak earnings growth, putting their high multiples at risk. Elsewhere, other more cyclically oriented businesses are nearer to trough levels on earnings and a reacceleration in earnings is more likely, along with a re-rating higher in the PE multiple.

Two additional areas that may be poised for outperformance in the coming years are smaller capitalization stocks and international stocks. Smaller companies in the value arena have a long run history of outperforming large caps but have been in a prolonged period of underperformance. Over the trailing 10-year period Large Cap Growth has outperformed its own long run average return by nearly sixteen percentage points, while Small Cap Value has underperformed its long run average by nine percentage points. These broad factor-based returns support our bottom-up research of individual companies where we are finding better value and lower risk outside of the mega-cap growth names. In the international arena, U.S. stocks are near a 70 year high in relative price performance versus the MSCI EAFE index. While the growth rate of U.S. stocks has been much better and the higher technology weighting in the U.S. has also helped, we think there will be pockets of opportunity in select international markets as well as U.S. based companies with a high percentage of overseas business.

In multi-asset class portfolios, we continue to allocate to alternative investments on both the liquid side and the private, less liquid side where appropriate to add sources of dry powder, incremental yield, and lower correlated sources of returns. Fixed income has a place in these portfolios as well as diversifiers and a ballast against volatility elsewhere in the portfolio. Here we favor managers with a strong record of balancing risk and reward in credit markets and navigating duration risk in search of acceptable yields.

Market volatility was obviously off the charts in 2020. Markets have climbed back in advance of a full recovery in the economy. Both GDP and employment are still below pre-pandemic levels. While we have a bit more clarity on both monetary policy and fiscal policy going into the New Year, there will certainly be more volatility as the White House changes administrations, the vaccine rollout continues, and tax, spending and regulatory bills are hashed out with the new Congressional committees (the balance of power from the GA senate races has yet to be determined at the time of this writing). The point is there will always be something to challenge markets (as well as the unknowns that come out of the blue like the pandemic), but it is how we react to them that matters in terms of our long range investment results and the impact these have on our personal planning goals.

As we put 2020 behind us and look forward to a New Year, we'd like to express our deep gratitude to you, our valued clients and friends. We take seriously the trust you have placed in us as stewards of your assets and for allowing us to accompany you on this incredible journey. Best wishes to you and your loved ones for a healthy and happy New Year!

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