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Fourth Quarter Commentary

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Stocks indices had a mixed quarter. Large cap outperformed small cap. Large cap growth[1] and the S&P 500 (+11.0%) led the major indices, powered specifically by Apple, Tesla, and Microsoft. Large, mid and small cap value stocks had positive returns, while small growth stocks were flat for the quarter.[1] Developed international markets also had a strong quarter, while emerging markets posted negative returns.[1] Gold was up and Bitcoin was down slightly. Hedge funds had mixed results, with credit-oriented funds up and long/short equity funds had mixed to negative results.

For the full year, most stock indices were up double digits, led by the S&P 500 (+28.7%). Small, mid, and large cap value indices were all up over 20%, while mid and small growth stocks were up +12.7% and 2.8% respectively. Small cap value outperformed small cap growth by 25.4%, the largest calendar year outperformance since 2000. Developed international markets were up +11.2%, while emerging markets were down 4.6%. Gold was down about 4% for the year, while Bitcoin returned 63%. Long/short equity hedge funds mostly underperformed broader equity markets, while distressed and credit funds generally gained in the teens.

For the quarter, Interest rate changes varied across the yield curve. Very short term rates (< 1 year) were essentially unchanged. Rates rose considerably in the “belly of the curve” (1-7 year maturities), in response to updated Federal Reserve projections. The 10-year yield fell slightly, while the yield on the longest maturing Treasury bond, the 30-year, fell 0.19%. The following are Treasury yields for various maturities:

Maturity*	12/31/2020	9/30/2021	12/31/2021
3 Month	0.08%	0.04%	0.05%
2 Year	0.12%	0.29%	0.73%
5 Year	0.36%	0.99%	1.26%
10 Year	0.94%	1.53%	1.51%
30 Year	1.67%	2.09%	1.90%

The markets seemed to climb a wall of worry in the quarter, as many of the concerns outlined in our last letter did occur. Another COVID variant appeared in late November, perhaps one of the fastest spreading viruses the world has ever seen. The supply chain issues have not been fixed. The Build Back Better plan was not passed. Enhanced child tax credit and other supplemental support programs lapsed. Inflation jumped to multi-decade highs. The Federal Reserve indicated a quicker end to the bond buying program and also projected more interest rate hikes next year. Still, stocks went up. Timing the market based on macro-economic concerns is risky (and why we don’t do it).

[1] Large cap growth = Russell 1000 Growth Index; Large cap value = Russell 1000 Value Index; Mid cap growth = Russell Mid Cap Growth Index; Mid Cap = Russell Mid Cap Index; Mid cap value = Russell Mid Cap Value Index; Small cap growth = Russell 2000 Growth Index; Small cap = Russell 2000 Index; Small cap growth = Russell 2000 Value Index; Developed international = MSCI EAFE Index; Emerging markets = MSCI Emerging Markets Index; Source: Morningstar

* Source: FactSet

That said, the most perplexing market seems to be the US Treasury market. Short term interest rates rose immediately after the Fed updated their projections for 2022. Longer term Treasury yields were unchanged or lower, which seems counterintuitive to what one would expect when inflation is at a multi-decade high (+6.9%) and US government debt is up 25% (to $28.9 trillion) since the end of 2019. The reason for that stability is the demand for Treasuries remains strong because the Fed buys and holds a sizable percentage of all Treasury issuance, banks tend to buy Treasuries when loan demand is tepid, and US interest rates are higher than most developed countries making our bond market appear relatively attractive to foreign investors. It is also possible the bond market is projecting limited to no long-term inflation. We will see how bond markets react once the Fed begins to buy fewer bonds.

It is difficult to say what this all means for US equities in the short term, though one can group them into four main scenarios. Should the US economy continue to grow with low interest rates and low inflation, growth stocks would likely outperform. If the US economy continues to grow, but in a structurally higher inflationary environment, we would expect value stocks of all market caps to outperform. Should the Federal Reserve move to crush inflation and tighten too quickly, pushing the economy toward or into a recession, equities would likely fall and bonds should outperform. Lastly, if the bond market believes inflation is far above what is "acceptable" and thinks the Fed is moving too slowly, then cash and short-term bonds would be safe havens.

Over the long-term, owning high quality, productive assets normally provide long-term growth and protects against the loss of purchasing power. Corporate earnings for 2021 are expected to be 30% higher than they were for 2019. US stocks have historically been one of the best investments to protect purchasing power, but investors should expect higher volatility as the Fed begins to tighten. High quality and well capitalized companies (the focus of our equity managers) can perform well in different economic environments, including recessions.

Diversification is critical to meet both the short- and long-term goals of our clients. Bond yields remain frustratingly low, but the income stream is certain and collecting the face value of a high-quality bond at maturity is also a near certainty, something that cannot be said for stocks. This is of great importance for those who take distributions from their investment accounts or for anyone who gets overly uncomfortable when stock market volatility surges—regardless of short-term returns. The goal is to "never be forced to sell" stocks in a down market, as that is how one permanently loses hard earned capital.

Diversification within equities also provides opportunities and protection in different disinflationary / inflationary periods, and owning an index is not enough. Indices are skewed by large weightings in a few holdings. Five stocks make up more than 20% of the S&P 500 index. The large cap growth index's top two holdings are Apple (11.5%) and Microsoft (10.7%). Should these highly valued stocks falter, those large cap indices may be in for a tough stretch, even while other parts of the market do well. It has happened before. The S&P 500 index closed at 1,469 on 12/31/1999. It would not close out the year at a higher level until 2013, yet other parts of the market did much better during that period, such as small cap value which was up 304% over the same time frame. Diversification, both in different asset classes and within asset classes, provides relative stability, as painful as it sometimes is to hold the underperformers. That stability gives confidence to stay in the market even through challenging periods and allows the entire portfolio to benefit from the power of compounding growth over time.