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# BREAK ON THROUGH TO THE OTHER SIDE

Scott Welch — Chief Investment Officer – Model Portfolios  
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*You know the day destroys the night  
Night divides the day  
Tried to run  
Tried to hide  
Break on through to the other side  
Break on through to the other side  
Break on through to the other side, yeah...*

*(From "Break on Through (to the Other Side)" by The Doors, 1967)*

I was on yet another conference call the other day, and the "icebreaker" question was, "What have you learned about yourself this year?" I am not the most introspective of people, so the question knocked me back for a second.

But after giving it some thought, my response was, "It was a year of confirmation. After seeing myself every day on videoconference calls, I confirmed that I have the perfect face for radio. But, more importantly, I confirmed that I am an optimist. If the spectrum is measured from Grinch to Pangloss, I definitely am on the Panglossian side of the scale." It is hard to imagine making it through 2020 with a pessimistic attitude.

What does being optimistic mean from an investment perspective? It means we are cautiously optimistic about the general economic and market environments—we think 2021 will be a "risk-on" year, especially in the second half, as the full impacts of both COVID-19 vaccinations and fiscal stimulus in the U.S. start working their ways through the system.

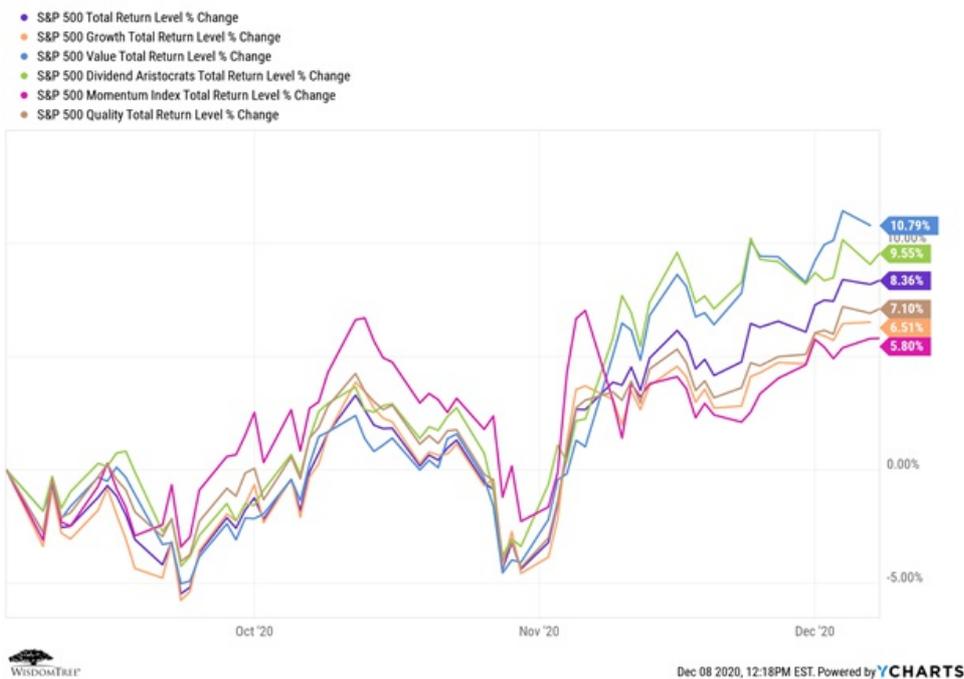
From an asset allocation perspective, here is how we see things:

1. The COVID-19 pandemic will hopefully soon be in the rearview mirror—a nightmare none of us will ever forget, but no longer the only thing we think about—let's call that for the second half of the year, maybe (being optimists) even Q2.
2. We believe our grandchildren will curse our names regarding the national debt and deficit—we are borrowing from them to maintain our current lifestyles, and neither political party seems inclined to slow it down much. When trying to explain this to nonfinancial folks, I ask them, "What if I gave you a new credit card with no spending limit and no requirement to pay anything back other than interest. How large would you live?" The answer, of course, is LARGE. The piper eventually must be paid, but not today, and the grasshoppers<sup>1</sup> who run Congress will eventually pass an additional fiscal stimulus package, which should provide a catalyst for positive economic growth.
3. We still prefer stocks to bonds. Rates will most likely grind higher from their current low levels, and the [yield curve](#) may continue to steepen. [Credit spreads](#) essentially have retraced back to their pre-pandemic levels, and we just don't see huge upside return potential. Furthermore, credit quality will be critical as we move through the year. Bonds (as measured by the [Bloomberg Barclays Aggregate Bond Index](#)) did their job in mitigating [downside risk](#) when the pandemic first hit, but have lagged equity markets (as measured by the [S&P 500 Index](#) and the [MSCI ACWI \(all world\) Index](#)) in the second half of the year:



Source: YCharts, data from 1/1/20–12/8/20. You cannot invest in an index, and past performance is no guarantee of future results. Source: YCharts, data from 1/1/20–12/8/20. You cannot invest in an index, and past performance is no guarantee of future results.

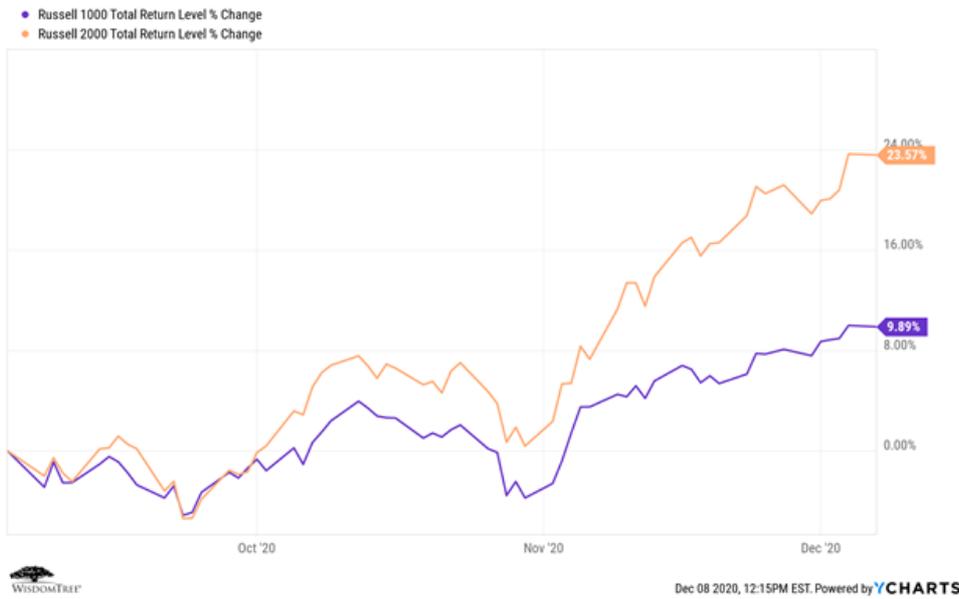
4. It’s too early to tell if “the great factor rotations” back toward [value](#) and [size](#) will continue, but there are signs suggesting they will<sup>2</sup>. This second chart shows the three-month results for different risk factors ([growth](#), [value](#), [dividends](#), [momentum](#) and [quality](#), all versus the broad market S&P 500 Index):



Source: YCharts, data from 9/8/20–12/8/20. You cannot invest in an index, and past performance is no guarantee of future results.

For definitions of terms in the chart, please visit our [glossary](#).

5. This third chart compares three-month returns for [large-cap](#) versus [small-cap](#) stocks (the [Russell 1000 Index](#) versus the [Russell 2000 Index](#)):



Source: YCharts, data from 9/8/20–12/8/20. You cannot invest in an index, and past results are no guarantee of future performance.

6. While size and value may be enjoying their day in the sun, this is not to suggest that growth no longer has a place in a well-diversified portfolio, as illustrated by comparing the three-month performance of the broad market S&P 500 Index to (a) the [Nasdaq 100 Index](#) (as a proxy for [mega-cap](#) tech stocks) and (b) the [S&P 500 Growth Index](#):



Source: YCharts, data from 9/8/20–12/8/20. You cannot invest in an index, and past results are no guarantee of future performance.

7. Global diversification still makes sense, especially if you believe that (a) non-U.S. growth and earnings will outpace the U.S. and (b) the U.S. dollar will continue to slide. First, here is a three-month comparison of the S&P 500 Index to (a) the MSCI EAFE (developed international) Index and (b) the [MSCI Emerging Markets \(EM\) Index](#):



Source: YCharts, data from 9/8/20–12/8/20. You cannot invest in an index, and past results are no guarantee of future performance.

8. Next is a YTD chart illustrating the movement of the U.S. dollar versus a diversified basket of currencies:



Source: YCharts, data from 1/1/20–12/8/20. You cannot invest in an index, and past results are no guarantee of future performance. The Dow Jones FXCM Dollar Index measures the value of a U.S. dollar versus a basket of currencies consisting of 25% euro, 25% yen, 25% British pound and 25% Australian dollar.

**Conclusion**

While we generally are optimistic about the prospects for 2021, we remain aware that unforeseen events can (and probably will) occur. As we headed into early 2020, who foresaw a global pandemic?

U.S.-China and U.S.-Iran relations remain rocky. Here at home we have upcoming Senate races in Georgia, the outcomes of which may have significant effects on the tax, regulatory, judicial and legislative environments as we head through 2021.

In summary, there are many issues that could alter our outlook and portfolio positioning. But based on what we know now, our asset allocation guidelines are as follows:

- 1. Stocks over bonds

2. We remain globally diversified. Relative to the MSCI ACWI Index, we remain slightly over-weight in the U.S. and EM and under-weight in EAFE (developed international)
3. Also relative to the MSCI ACWI Index, our equity portfolios maintain strategic tilts to small cap, value, yield and quality
4. Relative to the Bloomberg Barclays Aggregate Bond Index, our bond portfolios remain under-weight in duration and over-weight in credit. We also maintain a heavy focus on credit quality
5. We continue to believe that current income/yield is best delivered from our equity allocations instead of from taking excessive risk in our bond portfolios
6. Our portfolios remain highly diversified at both the asset class and [risk factor](#) levels

2021 may be the year we “break on through to the other side,” but we believe in building all-weather portfolios that can handle whatever comes our way.

We wish you all a very happy holiday season and a safe, prosperous and healthy 2021!

<sup>1</sup>This is a reference to the Aesop fable about the ant and the grasshopper, where the grasshopper pays no attention to the future and simply lives for today, then ends up on the outside of the anthill looking in when winter finally arrives.

<sup>2</sup>Including, for example, signs that we are entering a cyclical economic recovery when, historically, size and value factors have performed well. Also in the mix are simply the dramatic valuation differences between large-cap growth and the size and value factors. At some point it was reasonable to expect at least somewhat of a “mean reversion” of these valuations.

For standardized performance and the most recent month-end performance click [here](#) NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

For more investing insights, check out our [Economic & Market Outlook](#)

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You cannot invest directly in an index.

## DEFINITIONS

**Yield curve** : Graphical Depiction of interest rates on government bonds, with the current yield on the vertical axis and the years to maturity on the horizontal axis.

**Credit spread** : The portion of a bond's yield that compensates investors for taking credit risk.

**Bloomberg U.S. Aggregate Bond Index** : Represents the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, as well as mortgage and asset backed securities.

**Downside** : Currency depreciation.

**S&P 500 Index** : Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

**MSCI ACWI Index** : A free-float adjusted market capitalization-weighted index that is designed to measure the equity market performance of developed and emerging markets.

**Value** : Characterized by lower price levels relative to fundamentals, such as earnings or dividends. Prices are lower because investors are less certain of the performance of these fundamentals in the future. This term is also related to the Value Factor, which associates these stock characteristics with excess returns vs the market over time.

**Size** : Characterized by smaller companies rather than larger companies by market capitalization. This term is also related to the Size Factor, which associates smaller market-cap stocks with excess returns vs the market over time.

**Growth** : Characterized by higher price levels relative to fundamentals, such as dividends or earnings. Price levels are higher because investors are willing to pay more due to their expectations of future improvements in these fundamentals.

**Dividend** : A portion of corporate profits paid out to shareholders.

**Momentum** : Characterized by assets with recent price increase trends over time. This term is also associated with the Momentum Factor which associates these stock characteristics with excess return vs the market over time.

**Quality** : Characterized by higher efficiency and profitability. Typical measures include earnings, return on equity, return on assets, operating profitability as well as others. This term is also related to the Quality Factor, which associates these stock characteristics with excess returns vs the market over time.

**Large-Capitalization (Large-Cap)** : A term used by the investment community to refer to companies with a market capitalization value of more than \$10 billion. Large cap is an abbreviation of the term "large market capitalization". Market capitalization is calculated by multiplying the number of a company's shares outstanding by its stock price per share.

**Small caps** : new or relatively young companies that typically have a market capitalization between \$200 million to \$2 billion.

**Russell 1000 Index** : A measure of the performance of the 1,000 largest companies by market capitalization in the Russell 3000 Index.

**Russell 2000 Index** : Measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.

**Diversification** : A risk management strategy that mixes a wide variety of investments within a portfolio.

**Nasdaq 100 Index** : Includes 100 of the largest domestic and international non-financial companies listed on The Nasdaq Stock Market based on market capitalization. The Index reflects companies across major industry groups including computer hardware and software, telecommunications, retail/wholesale trade and biotechnology. It does not contain securities of financial companies, including investment companies.

**Mega Cap** : Market Capitalization over \$100 Billion.

**MSCI Emerging Market Index** : The MSCI Em (Emerging Markets) Index is a free-float weighted equity index that captures large and mid cap representation across Emerging Markets (EM) countries.