

FOR WHAT IT'S WORTH

Scott Welch — Chief Investment Officer, Model Portfolios
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*There's something happenin' here
what it is ain't exactly clear
there's a man with a gun over there
tellin' me I got to beware
I think it's time we stop, children
what's that sound
everybody look what's goin' down
There's battle lines being drawn
nobody's right if everybody's wrong
young people speakin' their minds
getting so much resistance from behind...
What a field day for the heat
a thousand people in the street
singing songs and carrying signs
mostly say hurray for our side...
Paranoia strikes deep
into your life it will creep
it starts when you're always afraid
step out of line the man come and take you away
(I think) It's time we stop,
hey what's that sound
everybody look what's goin' down*

(From "For What It's Worth" by Buffalo Springfield, 1966)

This song was released in 1966, just as the tumultuous late '60s were revving up—hippies, “flower power,” anti-war protests (some peaceful, some not), riots, assassinations, the destruction of cities and domestic terrorism.

But close your eyes, maybe rearrange a lyric or two, and the song would be equally applicable to the latter stages of 2020.

What remains undoubtedly true is that “nobody’s right if everybody’s wrong.” 2020 has been an *annus horribilis*, indeed. As Mark Twain frequently is credited with saying, “History doesn’t repeat itself, but it often rhymes.”

We currently are in the throes of a raucous presidential election, an ongoing COVID-19 pandemic and mass chaos and mayhem in many of our cities and towns. It is a time of uncertainty...at least outside the investment markets, which seem to be blissfully sailing along on the winds of an ongoing economic recovery, an expectation of further massive [fiscal stimulus](#) and seemingly perpetual easy [monetary policy](#).

As investors, we have little to no control over what happens in either the investment markets or “the real world.” All we can seek to control is how we position our portfolios to accommodate whatever comes our way.

In late July, we published our [Mid-Year Asset Allocation Outlook](#). Our views from then can be summarized as follows:

1. Stocks over bonds
2. U.S. and emerging markets (EM) over developed international Europe, Australia, Far East (EAFE)
3. Under-weight in duration and over-weight in [credit risk](#) (the spread over Treasuries charged to a given company based on its perceived default risk) with a focus on [quality](#) (that is, on companies with stronger balance sheets,

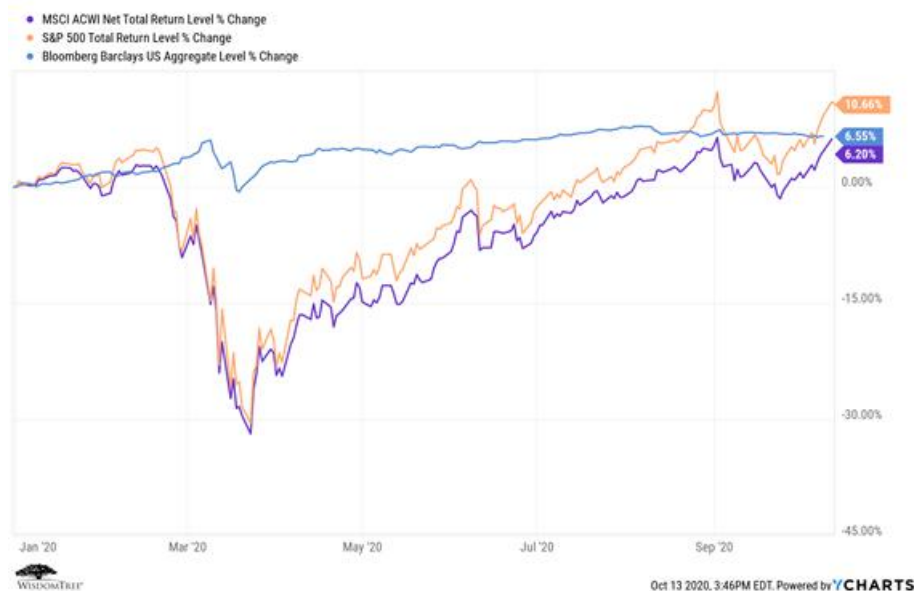
earnings and cash flows)

4. Maintain appropriate asset class and [risk factor diversification](#)

As we move into November, where do we currently stand on these four points?

1. Stocks over Bonds

The following chart compares how stocks and bonds have performed over the course of 2020:



Source: YCharts, as of 10/13/20. You cannot invest in an index. Past performance does not guarantee future results.

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

We see that bonds (as represented by the [Bloomberg Barclays Aggregate index](#)) dramatically outperformed during the worst of the downturn, but that stocks (as represented by the [MSCI ACWI Index](#) (total world market) and the [S&P 500 Index](#) (large-cap U.S. stocks)) essentially have caught up to or passed the total return performance of bonds. Given the current level of [rates](#) and [spreads](#) and overall market conditions, we believe this outperformance will continue, especially now that the worst of the earnings information appears to be behind us:

The Worst May Be Over for S&P 500 Earnings



Source: Ally Invest, S&P Capital IQ

Sources: Ally Invest, S&P Capital IQ, The Daily Shot, as of 10/13/20

2. U.S. and EM over Developed International (EAFE)

The following chart illustrates the YTD comparative performance of U.S. versus non-U.S. stocks:

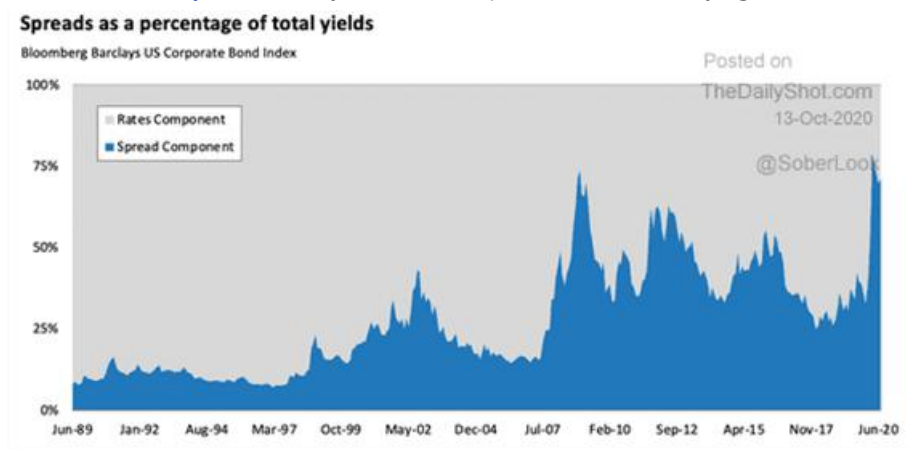


Source: YCharts, as of 10/13/20. You cannot invest in an index. Past performance does not guarantee future results.

As we expected, the U.S. (as represented by the S&P 500 Index) has outperformed non-U.S. (as represented by the MSCI EAFE Index), and emerging markets (as represented by the [MSCI Emerging Markets Index](#)) have outperformed the developed international markets (as represented by the MSCI EAFE Index). We believe the dollar may continue to slide generally downward (weaker), providing a tailwind to non-U.S. [risk assets](#), and valuations look slightly more attractive outside the U.S. (especially in EM, over a longer time horizon), but we think the underlying fundamentals of the U.S. market and our more rapid economic recovery will keep the U.S. solidly out in front over the medium term.

3. Under-Weight [Duration](#) and Over-Weight Credit with a Focus on [Quality](#)

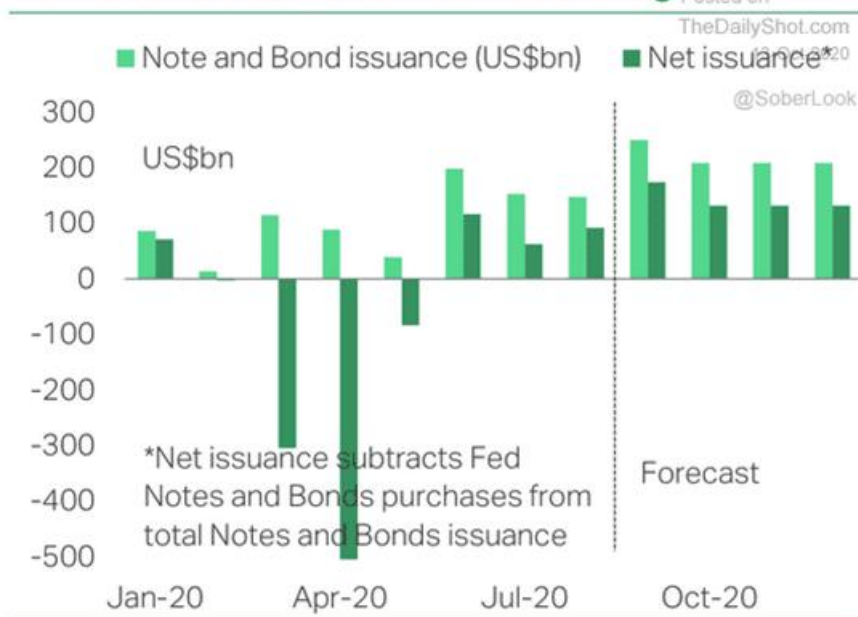
A couple of interesting charts illustrate while we still maintain this view. First is an illustration of how much of the [corporate bond](#) market's [yield](#) currently comes from spreads versus underlying [interest rates](#):



Sources: BMO Global Asset Management, The Daily Shot, as of 10/13/20. You cannot invest in an index. Past performance does not guarantee future results.

Given the low level of rates and an anticipation of further fiscal stimulus, we think the likely direction of rates from here is to "grind higher," corporate spreads to "grind tighter" and the yield curve to steepen. With the [10-year Treasury](#) currently trading at around 70–80 [basis points \(bps\)](#), even a small increase in rates would have a significant negative impact. This is what gives us pause about taking on excessive duration risk. In addition, there is a heavy load of new issuance in the pipeline:

Net issuance set to be near record high



Sources: The U.S. Treasury, Federal Reserve, TS Lombard, The Daily Shot, as of 10/13/20. For more details, please see this press release from the U.S. Treasury: <https://home.treasury.gov/news/press-releases/sm1077>.

The presence of the [Federal Reserve](#) within the corporate bond market continues to provide a strong technical backdrop, but the uncertainty of the virus's evolution and the political response to it makes credit selection paramount in the coming months. There will be winners and losers, and focusing on issuers with positive cash flow profiles and the capacity to secure additional funding (relative to their peers) could serve investors well.

4. Maintain Both Asset Class and Risk Factor Diversification

We've written before about the [importance of risk factor diversification](#). A quick glance at the WisdomTree "risk factor performance quilt" through the end of September illustrates this point nicely:

2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020 YTD
Momentum (-1.6%)	Value (46.32%)	Correlation (24.04%)	Quality (15.8%)	LowVol (19.36%)	Quality (10.9%)	LowVol (-23.16%)	Value (58.13%)	Quality (25.67%)	LowVol (12.31%)	Quality (18.82%)	Value (44.52%)	LowVol (17.2%)	Momentum (7.46%)	Value (19.44%)	Quality (25.42%)	LowVol (-1.22%)	Size (28.03%)	Correlation (7.54%)
LowVol (-2.56%)	WTUSMFU (21.43%)	Multifactor (17.42%)	Value (15.24%)	Momentum (17.42%)	Correlation (7.33%)	Momentum (-25.79%)	WTUSMFU (40.14%)	WTUSMFU (23.23%)	Momentum (17.73%)	Value (12.08%)	Size (35.77%)	Multifactor (16.54%)	LowVol (5.32%)	WTUSMFU (13.9%)	Size (22.21%)	Momentum (-2.14%)	Quality (27.97%)	Size (2.92%)
Multifactor (-2.87%)	Correlation (34.08%)	Value (19.65%)	Correlation (15.0%)	Value (17.36%)	Size (7.18%)	Multifactor (-32.59%)	Quality (38.07%)	Value (20.57%)	Multifactor (10.83%)	WTUSMFU (17.2%)	Correlation (35.31%)	Correlation (15.55%)	Quality (1.5%)	Quality (13.23%)	WTUSMFU (19.63%)	Correlation (-3.67%)	Value (27.75%)	Momentum (-0.41%)
Correlation (-7.41%)	Quality (32.91%)	LowVol (10.53%)	Multifactor (10.05%)	Multifactor (15.42%)	Multifactor (8.85%)	Quality (-35.08%)	Correlation (32.81%)	Correlation (20.12%)	Correlation (4.41%)	Size (16.7%)	Correlation (34.81%)	Momentum (15.32%)	Size (0.66%)	LowVol (13.06%)	Value (19.1%)	Multifactor (-4.01%)	LowVol (27.45%)	Quality (-0.62%)
Quality (-8.27%)	Multifactor (30.97%)	Quality (17.46%)	WTUSMFU (11.18%)	WTUSMFU (14.6%)	WTUSMFU (5.77%)	Size (-36.67%)	Size (32.79%)	Momentum (17.56%)	Quality (3.4%)	Multifactor (15.67%)	Quality (33.78%)	Size (14.29%)	Multifactor (0.55%)	Size (11.59%)	Momentum (18.77%)	Size (-4.38%)	WTUSMFU (27.1%)	WTUSMFU (-1.8%)
Value (-15.47%)	Size (30.15%)	WTUSMFU (17.44%)	Size (7.59%)	Size (11.18%)	Momentum (5.59%)	Value (-38.85%)	Value (17.38%)	Multifactor (24.59%)	Multifactor (13.15%)	Size (15.52%)	Multifactor (32.23%)	Value (13.58%)	WTUSMFU (-1.31%)	Momentum (9.95%)	Multifactor (17.82%)	Quality (-6.65%)	Momentum (26.01%)	Multifactor (-4.31%)
WTUSMFU (-17.97%)	LowVol (27.01%)	Momentum (17.02%)	Momentum (5.59%)	Quality (12.57%)	LowVol (11.14%)	WTUSMFU (-38.85%)	LowVol (20.2%)	LowVol (15.04%)	WTUSMFU (0.13%)	Momentum (13.15%)	Momentum (27.99%)	Quality (13.52%)	Value (-5.9%)	Multifactor (17.07%)	LowVol (17.24%)	WTUSMFU (-7.85%)	Correlation (23.15%)	LowVol (-6.36%)
Size (-22.11%)	Momentum (23.57%)	Size (13.16%)	LowVol (8.07%)	Correlation (11.24%)	Value (0.27%)	Correlation (-41.0%)	Momentum (15.12%)	Size (14.5%)	Value (-1.24%)	LowVol (12.9%)	LowVol (23.72%)	WTUSMFU (12.72%)	Correlation (-7.79%)	Correlation (7.55%)	Correlation (13.31%)	Value (-12.23%)	Multifactor (20.11%)	Value (-15.52%)

Sources: WisdomTree, FactSet, as of 9/30/20. The starting universe for the referenced "factor portfolio" is the 400 largest companies listed in the U.S. Securities in the Low Correlation portfolio are selected based on their trailing 6- and 12-month correlation versus the broad market. Securities in the Low Volatility portfolio are selected based on their trailing 12-month standard deviation. Securities in the Momentum portfolio are selected based on their trailing 6- and 12-month risk-adjusted performance. Securities in the Quality portfolio are selected based on stronger current and historical (three-year) measures of profitability compared to their peers in the same GICS industry using four main variables: Return on Equity, Return on Assets, Gross Profit over Assets, Cash Flow over Assets. Securities in the Value portfolio are selected based on more attractive valuation metrics compared to their peers in the same GICS industry using six main variables: Sales-to-Price, Book-to-Price, Earnings-to-Price, EBITDA-to-Enterprise Value, Operating Cash Flow-to-Price. Securities in the Size portfolio are selected based on their market capitalization compared to their peers in the starting universe. Securities in the Multifactor portfolio are selected based on a composite score calculated by their Low Correlation, Momentum, Quality and Value scores.

In summary, while political and social events have created an environment of high uncertainty, from an investment perspective we remain comfortable with our mid-year allocation recommendations.

If you agree with us, [we have a variety of actionable ideas](#) that may be of interest. For financial professionals to view, we also offer an array of Model Portfolios that may fit your longer-term outlooks or complement existing portfolios you are managing.

Right now, there seems to be little question that, "There's something happenin' here. What it is ain't exactly clear." But if you build your portfolios to weather all storms, you may be less inclined to be "always afraid."

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](#)

View the online version of this article [here](#).

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You cannot invest directly in an index.

DEFINITIONS

Fiscal Stimulus : Using fiscal policy as a tool to provide economic growth.

Monetary policy : Actions of a central bank or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.

Credit risk : The risk that a borrower will not meet their contractual obligations in conjunction with an investment.

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.

Risk : Also standard deviation, which measures the spread of actual returns around an average return during a specific period. Higher risk indicates greater potential for returns to be farther away from this average.

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

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.

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.

Interest rates : The rate at which interest is paid by a borrower for the use of money.

Spread : Typically refers to a difference between a measure of yield for one asset class and a measure of yield for either a different subset of that asset class or a different asset class entirely.

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.

Duration : A measure of a bond's sensitivity to changes in interest rates. The weighted average accounts for the various durations of the bonds purchased as well as the proportion of the total government bond portfolio that they make up.

Corporate Bonds : a debt security issued by a corporation.

Yield : The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.

10- Year Treasury : a debt obligation of the U.S. government with an original maturity of ten years.

Basis point : 1/100th of 1 percent.

Federal Reserve : The Federal Reserve System is the central banking system of the United States.