Alphabet Soup

Quick Look

- While still in the early stages of the recovery, recent economic data has been stronger than what was predicted six months ago.
- The S&P 500 Index fully recovered from a 34% drawdown in just 126 trading days, far and away the fastest recovery off of a recessionary bear market in history.
- While true that the S&P 500 has returned to all-time highs, the majority of global equity indices are still negative for the year. Developed International stocks, U.S. Small Cap stocks, and U.S. Value stocks are all still down between 9% and 12%.
- Propelling the S&P 500 Index back to all-time highs this quarter has been the utter dominance of the five largest stocks in the Index, which are Apple, Microsoft, Amazon, Alphabet, and Facebook. These five stocks have gained on average 40% year-to-date, while the average stock in the S&P 500 Index has declined 5%.
- Over the past 10-year rolling period, the U.S. index has gained 14.7% above cash. This is more than double the 6.3% historical return above cash, and is in the 1st percentile of rolling 10-year period rankings.
- Our internal research for the Value factor, which uses Fama-French HML monthly data back to 1963, shows the Value premium at its 100th percentile readings across any rolling time period.
- The Value premium exists because of the behavioral tendency of investors to eventually overvalue great companies.

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About Opus Capital Management

Opus Capital is an evidenced-based investment advisory firm driven by our overriding mission to help people. We believe the marriage of comprehensive financial planning + statistically proven investment principles creates the clearest roadmap to long-term success.

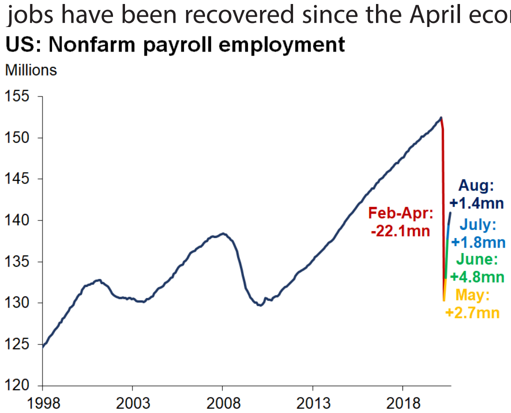
We are independent and transparent in all aspects of investment management decision making and financial planning. We selectively partner with like-minded individuals and families, endowments, foundations, and 401(k) plans in 28 states.

Quarterly Investment Letter, Q3 2020

A popular way for economists to summarize the state of the COVID-recession recovery has been to describe its shape in the form of a letter. President Trump and his staff have pushed the promise of a V-shaped recovery, while others have speculated the path would be U-shaped, or L-shaped, or W-shaped, or even Nike-Swoosh shaped (technically not a letter).

The letter shape of the economy has been one of the more frequent questions we have been asked since the COVID-shutdown, and one that has been challenging to answer with certainty, due to the rapidly-changing nature of the pandemic. An L-shape seemed in play at the onset of COVID-19 when the duration of the mandatory shutdown was unknown. A U-shape was in consideration given that it was the shape that best described our last recession and was still fresh in minds. A W-shape remains plausible in the event of a major second wave, though our advances in medical treatment and understanding of the virus, coupled with a lack of appetite for another shutdown, has diminished its likelihood.

Some of the recent economic data has very much been V-shape like, such as an all-time high in total aggregate retail sales or the record monthly surge in home sales. The recovery has been quicker and stronger than what was predicted six months ago, propelled by the improving stats of the pandemic and, chiefly, the bazooka of stimulus fired at the end of March, which fully replaced personal income and then some through the expiration of the CARES Act at the end of July. The employment chart below nicely conveys the optimism of a V-shape, as 10.7 million jobs have been recovered since the April economic bottom. It also reveals how daunting the task will be to complete the remaining half of the V-shape, as we still are not halfway back to recovering all of the jobs lost this spring. To put that in perspective, the 11 million jobs still lost is higher than the 9 million jobs lost during the entirety of the 25 months of the Great Recession, a deficit that took five U-shaped years to recover.



Source: Oxford Economics/Haver Analytics

The most often cited V-shape indication has been the U.S. stock market (if represented by the S&P 500 Index). While the market is not the economy, the market often leads the economy, and the stock market's rally has been nothing short of extraordinary. The S&P 500 Index fully recovered from a bear market correction in just 126 trading days, far and away the fastest recovery in history. The crash in February-March wasn't just your garden-variety bear market either; at 34%, it was the fifth largest drawdown since World War II. Bear market recessions have taken, on average, nearly three years to reach new all-time highs. A sluggish September notwithstanding, the S&P 500 enters October with a positive return for the year.

Source: WSJ

The most recent letter to enter the economic vernacular is the K-shape, which describes the diverging paths, or separate trajectories, as a result of the pandemic. Some have faced significant hardships (be it health or financial), while others have seen prosperity. Some workers have had the ability to work from home; others, obviously, cannot. Unfortunately, a number of the occupations that are comprised of lower-wage workers – cashiers, cooks, retail sales, etc. – cannot work from home, and represent a large swath of the jobs lost (some temporary, some permanent) this year. The cruel nature of the pandemic has been the segmentation of winners and losers, picking at the scabs leftover from the last recession (urban vs. rural, education level, etc).

U.S. EQUITY RETURNS (%)

As of 09/30/20	Q3 2020	1-Year	3-Year	5-Year	10-Year
S&P 500	8.9	15.2	12.3	14.2	13.7
Russell 1000 (Large Cap) Growth	13.2	37.5	21.7	20.1	17.3
Russell 1000 (Large Cap) Value	5.6	-5.0	2.6	7.7	10.0
Russell 2000	4.9	0.4	1.8	8.0	9.9
Russell 2000 (Small Cap) Growth	7.2	15.7	8.2	11.4	12.3
Russell 2000 (Small Cap) Value	2.6	-14.9	-5.1	4.1	7.1

Source: Morningstar

Continued from page 2 . . .

Upon deeper examination, the K-shape recovery is an apt depiction of equity investing as well. While true that the S&P 500 has returned to all-time highs, the majority of global equity indices are still negative for the year. Developed International stocks, U.S. Small Cap stocks, and U.S. Value stocks are all still down between 9% and 12%, weighing on overall portfolio returns.

Upward K-Shape

Propelling the S&P 500 Index back to all-time highs this quarter has been the utter dominance of the five largest stocks in the index, which are Apple, Microsoft, Amazon, Alphabet, and Facebook. These five stocks have gained on average 40% year-to-date, while the average stock in the S&P 500 Index has declined 5%. These five stocks now represent a staggering one-quarter of the entire S&P 500 Index (and one-half of the NASDAQ Index), the largest concentration since at least 1980, as far back as S&P Dow Jones Indices data goes. They also have a higher combined market capitalization than every country in the world, with the exception of China. All five are classified as Growth stocks with above-average earnings growth and profitability, fundamentals the market favored during the previous low growth and low interest rate recovery. During the pandemic, they have also gained the additional label as "safe stocks", a small pocket of stability during the shutdown.

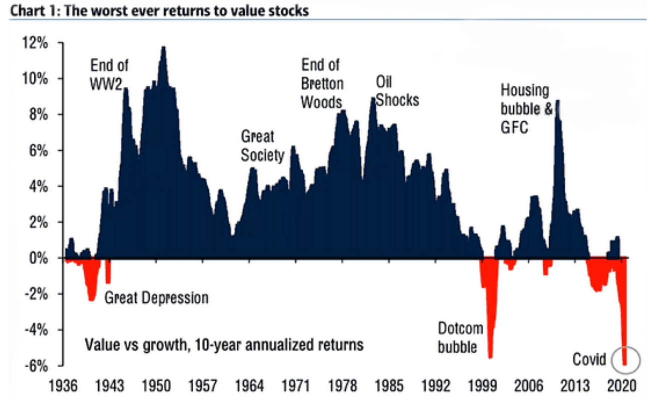
The U.S. Indexed portion of portfolios has done extraordinarily well, not just during the recovery, but over the past decade. Over the past 10-year rolling period, the U.S. index has gained 14.7% above cash (using Fama-French data). This is more than double the 6.3% historical return above cash, and in the 1st percentile of rolling 10-year period rankings. So while absolute Index returns are not at peak late-1990's levels, cash in the late 1990's earned as much as 6%. Cash in today's market earns 0%, making today's Index returns just as profitable as the late 1990's when measured as a premium against the alternative of cash.

As many of our clients know, one of the core principles of our portfolio construction is our emphasis on indexing. Capturing the premium that stocks provide over riskless assets or cash (known as market beta) as cheaply and efficiently as possible is the primary driver of portfolio returns. While positive market beta isn't guaranteed (a 10-year rolling period was negative as recently as November 2010), it has historically provided positive results two out of every three years and 95% of 10-year rolling periods. Because of this, the S&P 500 Index is the largest position in all but our most risk-averse portfolios, and the five stocks mentioned - Apple, Microsoft, Amazon, Alphabet, and Facebook - also currently represent our five largest stock weightings in client portfolios. These five stocks have lifted the S&P 500 head and shoulders above all other major equity indices, but also pushed the market's current valuation to 20-year highs.

Downward K-Shape

We also carry a modest Value tilt in our portfolios because of the long-term affirmation of the Value factor premium, which is the evidence that cheap stocks outperform expensive stocks in the long run. The reason for its existence is largely behavioral; investors get overexcited about the growth prospects of firms, bidding up their valuations to excessive levels. Statistically speaking, the Value premium has been close to 5% annualized since 1927, and has been additive 63% of rolling one-year periods and 86% of rolling ten-year periods. While these statistics suggest the existence of a Value premium is both persistent and pervasive, it is not fool-proof, and can experience times of underperformance. As seen in the chart below, Value has gone through three major periods of underperformance: The Great Depression, The Dot-Com Bubble, and the last decade, of which the K-shaped divergence of stock returns this year has led to the worst-ever rolling returns for Value stocks.

Chart 1: The worst ever returns to value stocks

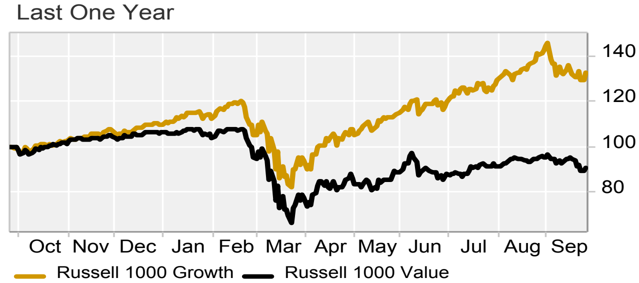


Source: BofA Research Investment Committee, Fama & French.

Over the past one year, Growth has outpaced Value by more than 40%, which is the largest rolling one-year spread in history between the two classifications. The K-shape nature of the stock market rally can be seen by the divergence in performance of the Technology sector (up 29%), and industries such as online retailing and biotech, which have been either unaffected or, in some cases, benefitted by the pandemic, versus sectors such as Energy (down 48% YTD), and Financials (down 20% YTD), both of which were dealt demand shocks from the pandemic.

Russell 1000 Growth vs Russell 1000 Value

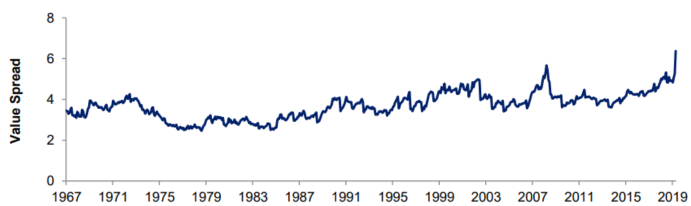
Last One Year



Source: FactSet

When discussing Growth and Value, the designation between the two depends solely on a fundamental measure of an earnings value, not the industry they are in. Technology stocks can be value stocks, just as Financial and Energy stocks can be growth stocks. Historically speaking though, Technology is far more represented in Growth, while Financials and Energy are classic Value sectors. While the Technology vs. Financials/ Energy performance divergence explains a predominance of Value underperformance, the recent exacerbation of Growth dominance can also be attributed to multiple expansion in Growth stocks, which are trading at expensive multiples on rising expectations. Research from AQR earlier this year revealed that even if the mega-cap stocks are removed, and even if technology is excluded, that the spread between cheap and expensive stocks is still at its widest level ever. The chart below shows that even in an equal-weight, industry-neutral portfolio, expensive stocks are more than six times more expensive than cheap stocks (the average Value spread is 4x). Our internal research for Value, which uses Fama-French HML monthly data back to 1963, shows the Value premium at its 100th percentile readings across any rolling time period.

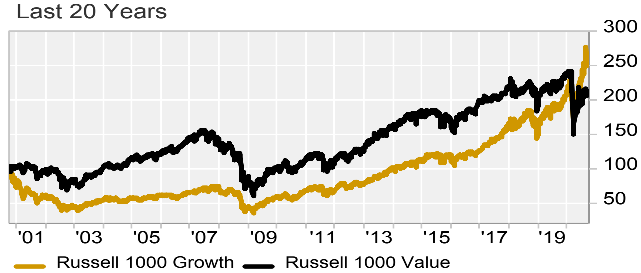
Price-to-Book Spread, Equal-Weighted Top 1000 Stocks, Industry-Neutral
December 31, 1967 – March 31, 2020



Source: AQR

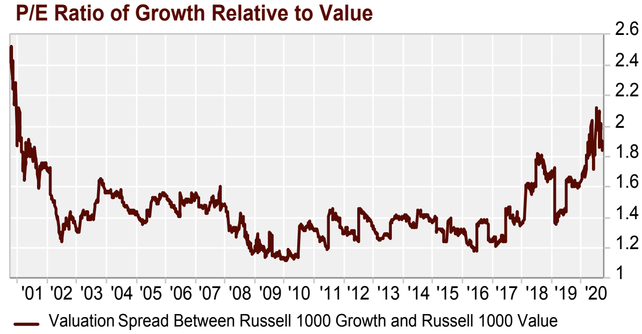
The K-shaped returns from this year have actually propelled rolling 20-year returns for Growth slightly above Value for the first time since 2000, something which has occurred only about 5% of the time since 1927. Though an extreme example, once the Dot-Com bubble burst, Growth fell dramatically, trailing Value stocks by more than 60% one year later, and triggering a drawdown of the Growth Index that took 14 years to fully recover. Interestingly, unlike the Dot-Com era, in which the spread was driven by a euphoria for expensive stocks, the current spread has widened due to a depression in prices in cheap stocks. This reinforces the pandemic-fueled K-shaped market divergence, in which, a portion of the market is being left for dead.

Russell 1000 Growth vs Russell 1000 Value
Last 20 Years



Source: FactSet

P/E Ratio of Growth Relative to Value



Source: FactSet

Timing the moment that triggers the Value resurgence is extremely difficult. Even with 100th percentile readings, there is certainly some level of odds that this period of Value underperformance could continue to persist. That said, we believe a Value-tilted allocation makes sense presently for a multitude of outcomes. Risk-averse investors focused on near-term election uncertainty (potentially ushering in changes to capital gain and corporate tax rates, and/or tougher federal regulations), or simply elevated stock market valuations that could impact the top-heavy S&P 500, could see a Value/Quality combo tilt provide some means of downside protection. Income-oriented investors can capture a 2% higher dividend in a Value ETF than in a Growth ETF. For more aggressive investors, we would argue that once we get to the other side of the pandemic, the odds favor market leadership shifting away from Tech Growth dominance and into the more downtrodden components of the market, as the economy returns to a sense of normalcy.

INTERNATIONAL RETURNS (%)

As of 09/30/20	Q3 2020	1-Year	3-Year	5-Year	10-Year
Int'l Developed ex US	4.8	0.5	0.6	5.3	4.6
Emerging Markets	9.6	10.5	2.4	9.0	2.5

Source: Morningstar

FIXED INCOME RETURNS (%)

As of 09/30/20	Q3 2020	1-Year	3-Year	5-Year	10-Year
Aggregate Bond	0.6	7.0	5.2	4.2	3.6
Muni	1.3	3.1	3.5	3.1	3.3
Int'l Bonds	3.0	5.0	2.6	3.5	1.8
High-Yield	4.3	1.3	2.9	5.2	5.3
Short-Term	1.0	3.3	2.8	2.4	2.0
90-Day T-Bill	0.0	0.9	1.6	1.2	0.6

Source: Morningstar

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