SEGALL BRYANT & HAMILL

1ST QUARTER 2021

SBH NEWSLETTER

Thoughts on the Current Environment

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... in the short run the stock market acts like a "voting machine" (reflecting all kinds of irrational attitudes and expectations), while functioning in the long run more like a "weighing machine" (reflecting a firm's true value).

—Warren Buffett, 1973

It's Time to Come Out of the Storm Cellar

Among its many dubious distinctions, the year 2020 is the clear winner in the "Annus Horribilis" category for the first two decades of the 21st century and stands as the early leader in the "Century Class" crown, too. Amid the disruption caused to daily life and the stresses and strains created in every form of normal business and social activity, what went on in the financial markets last year can be a legitimate cause for wonder. The best explanation we can offer is that just as viruses are a fact of life on earth so, too, is the law of gravity, which includes the notion that water, like all liquids, seeks its lowest level. Water bursting from a ruptured dam generates a flood that follows, which scours the earth on its drive to the sea, taking with it everything in its path. Similarly, in response to the pandemic, the governments of the world unleashed huge flows of liquidity, that is, cash, to maintain their economies, and the tidal wave of financial liquidity carried the prices of virtually every financial asset to higher levels in the process, just as the aftermath left portions of the economy devastated.

The End of the Party?

Interest rates ended the year at or very close to zero in the U.S., and well below zero in many developed countries. Trying to determine the discount rate to value the earnings of companies' shares (public and private) is a challenge.[1] The lower the discount rate, after all, the higher the upper limit of valuation ranges can be justified. This is a topic which we have come back to on many occasions. The inexorable force of adding liquidity to the financial system, whether in crisis or not, for more than a decade, combined with a consensus about the virtues of passive investing, which focuses that liquidity onto a small group of names, can create great momentum which can push stock prices beyond the constraints of gravity and into the stratosphere.

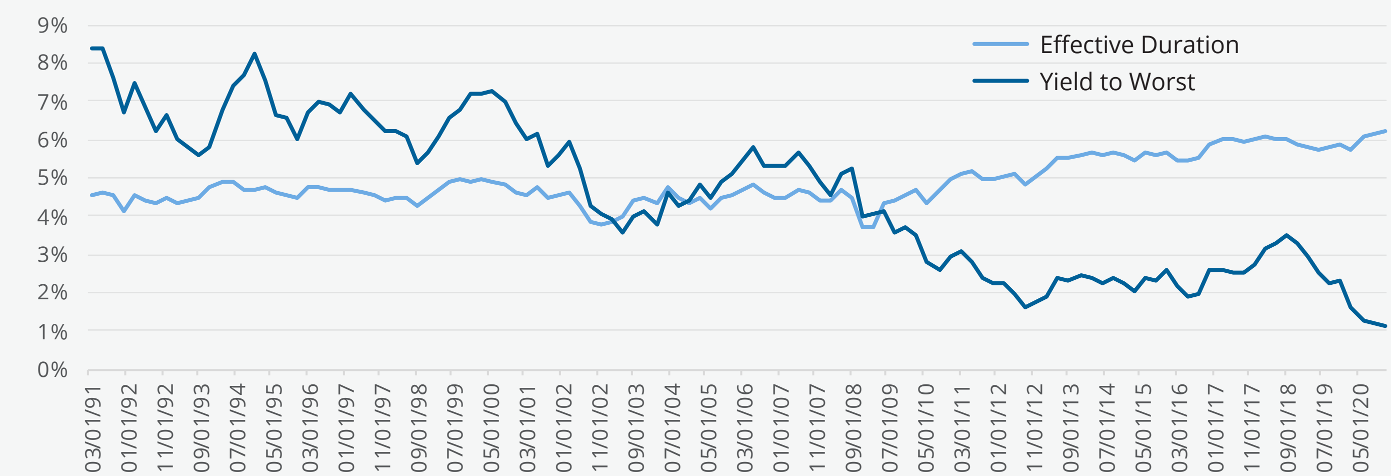
As Herbert Stein, a former chairman of the Council of Economic Advisors put it, "If something cannot go on forever, it will stop."[2] In other words, we know this trend can continue to further extremes even as the risks of staying to the end of the party grow larger and larger. Near the end of the Tech bubble in the late '90s, I recall an exercise we did which tried to reverse engineer the valuation the market was putting on Microsoft. Using the most aggressive assumptions we could apply, we determined the market's pricing of Microsoft would require every man, woman, and child in America to own 1.6 computers, all running Windows 95. There is another lesson about the aftermath of a burst bubble that Microsoft taught us.

The consensus forecast of Wall Street analysts in 1999 was that Microsoft's earnings would grow steadily between 12-15% each year for "a long time." Indeed, in 2012, Microsoft's earnings had grown by 13% per year, since 1999.[3] The date chosen for the end of the exercise—2012—was picked because Microsoft's share price didn't return to its 2000 bubble highs until then.

Seeking safety in traditional fixed income investments is hard to do as 2021 opens. The historical appeal of bonds has always been the steady stream of income payments they generate coupled with the promise of the return of principal. A year ago, the yield on the 10-year U.S. Treasury note, what we consider to be the most important price in the world, was 1.8%. We wondered then if this was too low to function in its role as setting valuations for everything from home mortgages to CD rates to P/E multiples on stocks. Twelve months later, that yield was down to 0.9%. At such levels, it is hard to think that this yield or the current yield on investment grade bonds, or the return on less than investment grade bonds, can function as bonds traditionally do.

The chart below shows that as interest rates decline, the price sensitivity to changes in interest rates of bonds increases. Recall that prices of existing bonds move inversely to interest rates. Not only are bonds not providing the stream of income investors have historically expected, but they have also become sources of volatility rather than of stability to the market value of a portfolio.

BARCLAYS US AGGREGATE YIELD VS DURATION (30 YEARS)



Source: FactSet, SBH Research.

[1] This rate, driven by market forces typically, is built on the notion that capital is compensated for taking risk, whether in the form of credit risk ("Can the borrower repay what is lent?") or time ("Will the borrower be able to repay when due?). In the case of stocks, which have no maturity date, the discount rate — to simplify it a lot — can be thought of as the inverse of the Price/Earnings ratio — a standard tool for valuing stocks.

[2] Herbert Stein, Jan. 16, 1968, in testimony before the Joint Economic Committee of Congress.

[3] FactSet, SBH Research. I have no doubt that a similar exercise today involving Tesla would lead to an absurd conclusion about the number of Electric Vehicles (EVs) every driving age human on the planet will own in 10 years, all Teslas, of course, and to a huge hue and cry by the company's devotees for such a lack of faith.

What Next?

In the COVID era aftermath, the reasonable question of every holder of financial assets and their managers must be, what next? Readers with a good memory will recall that we had essentially the same question a year ago. We wondered about the long-term growth potential of the global economy and the ramifications of huge debt loads reaching back to the end of the Global Financial Crisis. And then COVID intervened, and prices of all financial assets plunged. We expressed the view that until a safe and effective vaccine was in place, forecasting a resumption of "normal" life, let alone a recovery, was an exercise in futility. With the success of Operation Warp Speed to produce safe and effective vaccines, we can now return to our question of last year: what investment categories could provide a reasonable return and at an acceptable degree of risk?

The stupendous efforts of the central banks of the world partly kept much of the global economy functional, if not thriving. As we noted at the opening, the flow of liquidity seemed to find an easier pathway in the financial markets. That is the good news; the bad news is that savers, from pension funds and endowments to retirees, face an even smaller opportunity set than usual for all of the reasoning previously mentioned. Within the realm of the equity markets, we think there are three places investors may find opportunity. The first is in the international markets, especially emerging markets, albeit with a large warning about China. The other two, places in the domestic markets, are small cap companies, which should enjoy large earnings rebounds as the U.S. economy re-opens, and private equity investments. We understand that many investors cannot access this opportunity, but we think that those who can, should consider it.

First, international equities. The U.S. stock market took the gold medal in 2020. In a crisis, capital flows to safety, and safety is found in high quality. Only the securities of the best and most durable issuers, whether stocks or bonds, can be sold anywhere near "fair value." As the crisis seems to be abating, a surprisingly large valuation gap between U.S. stocks and their foreign brethren remains in place.

We think the gap will close for several reasons. The MSCI United States Index outperformed the MSCI World Ex-U.S. Index, earning 13.4% per year versus 5.2% over the last decade. Over half of that differential, 5.7%, was attributable to the impact of the so-called FAANGs[4] and the rest of the Technology sector.[5] The law of large numbers suggests that repeating that in the coming years is quite unlikely. Even a small reversal in momentum can re-direct investor interest to a segment of the market that appears "undervalued." Our preference between the Developed Market segment and Emerging Markets (EM) is with the Emerging Markets side. Most EM economies are already beginning to recover, and their governments are running stimulative fiscal policies. At the same time, their export activity is leaving them less vulnerable to balance of payment adjustments. A reason this might not be implausible is that 10 years ago, about 20% of the emerging markets segment of the MSCI Emerging Markets Index was made up of old economy Energy and Materials, and Technology was 10%. Today, those relationships are reversed. Finally, equity valuations of EM equities are less than that of Europe.

Similarly, in the small cap part of the domestic market, valuations relative to large caps are at historical lows, about which our research group has written in the last twelve months.[6] Below is a link to access papers from our Equity Strategy teams on this topic which we'd be glad to share with you on request.

Finally, regarding the opportunity in private equity, we note that shrinkage in the number of publicly traded equities continues. In 2010, there were 19,000 companies traded on public markets in north America and Europe versus roughly 7,800 in the privately backed space. As of the most recent data, the relationship was much tighter: 14,000 vs 10,000. More private companies are taking longer to season and build durable business models, which their private owners can capture before they come to public ownership.

[4] The acronym that has been given to a group of large cap domestic companies that have thrived in the last decade due to their application of technology: Facebook, Apple, Amazon, Google, Netflix. Microsoft is generally included as well.

[5] MSCI, FactSet, SBH research.

[6] https://www.sbhic.com/media-center/insights/

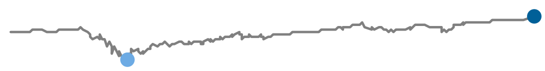
A Final Thought

The Pandemic ought to be an object lesson in humility for those who think to offer forecasts. Confidence in or degree of certainty expressed in a forecast will not make it so. The virus that burst forth upon us had begun to infect people even as 2020 was starting and grew to pandemic status within months. None of the year-end forecasts of economists, strategists, or pundits had any usefulness within six weeks or so of the new year. Financial forecasts, whether built on elaborate models or throwing darts on a dartboard, should require a Surgeon General like warning at the top: "Reading this forecast can be injurious to your financial health. Care must be exercised in accepting its conclusion." That also applies, of course, to this letter you have now finished reading.

Wishing a healthy, safe, and happy new year to all who have done so, including those who just skipped to the end, too.

MARKET BAROMETERS

AS OF 12/31/20

	Jan. 2, 2020	1Q20 2Q20 3Q20 4Q20	Dec. 31, 2020	Low	High
Dow Jones Industrial Index	28,868.80		30,606.48	**18,591.93**	**30,606.48**
S&P 500 Index	3,257.85		3,756.07	**2,237.40**	**3,756.07**
Russell 3000 Stock Index	1,906.50		2,248.44	**1,288.04**	**2,248.44**
Russell 2000 Stock Index	1,666.77		1,974.86	**991.16**	**2,007.10**
Russell Midcap Growth Index	1,242.09		1,655.93	**844.03**	**1,690.39**
Bloomberg Barclays Aggregate Index	2,228.19		2,392.02	**2,211.31**	**2,400.81**
Barclays Muni Bond Index	1,273.05		1,337.84	**1,174.65**	**1,337.87**
Gold (Price/Oz) London AM Fix	1,520.55		1,891.10	**1,472.35**	**2,061.50**
Goldman Commodity Index	2,595.65		1,976.96	**1,249.25**	**2,642.50**

Source: Bloomberg.

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