Q4 2020

Maclura Investments

2021 Outlook

Clay Brethour, CFA

"It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness..."

As 2020 concluded, most would classify it as a miserable year, but for investors it was extraordinary. When contemplating how to concisely summarize the past year, it seemed Charles Dickens's introductory sentence of A Tale of Two Cities written nearly 200 years ago aptly fulfilled that task.

The Morningstar US Market Index, a broad representation of the overall equities market, was up 20.90% for the year, this after a strong 2019 when the market was up 31.22%. With all of the circumstances surrounding 2020, this is a remarkable feat. Nonetheless, broad market indexes mask the vast divergence that investors had relative to their investment style for the year: growth versus value, as illustrated in the table below. It truly was the best of times for growth investors, while value investors continued to struggle. While some market pundits have been calling out for some time now that value stocks are poised to be positioned to take the market leadership away from growth stocks, I am not particularly convinced of their arguments, on which I will elaborate more in my Outlook for 2021 section.

	Morningstar Index Market Returns	2015	2016	2017	2018	2019	2020				
							1st Qtr.	2nd Qtr.	3rd Qtr.	4th Qtr.	2020
Growth	U.S. Growth	5.54%	3.16%	29.52%	0.78%	35.90%	-11.50%	29.86%	11.72%	12.66%	44.65%
	Large Growth	7.71%	1.79%	31.15%	2.94%	33.81%	-11.51%	26.60%	13.83%	8.89%	38.86%
	Mid Growth	-0.71%	6.46%	25.67%	-3.16%	36.01%	-17.00%	34.66%	9.56%	19.38%	46.17%
	Small Growth	-0.18%	9.61%	23.77%	-5.67%	27.60%	-21.45%	32.84%	7.35%	28.12%	43.52%
Value	U.S. Value	-2.16%	20.79%	14.23%	-7.51%	25.09%	-28.43%	13.82%	3.28%	17.29%	-1.31%
	Large Value	-1.43%	18.91%	15.09%	-5.90%	25.70%	-25.10%	12.45%	2.95%	14.62%	-0.62%
	Mid Value	-2.57%	25.21%	13.02%	-10.63%	24.81%	-35.52%	18.78%	4.44%	20.32%	-3.76%
	Small Value	-8.65%	27.96%	8.40%	-16.61%	19.96%	-39.68%	21.85%	2.99%	33.42%	1.01%

The sectors reported in the table below are the sectors in which Maclura Investments primarily traffics for building its clients' custom portfolios. Understanding the sectors and how they are differently weighted in value and growth indexes can help explain the difference in performance between the two styles. For instance, the value indexes' largest sector tends to be the financial industry, which had the lowest annual performance for the sectors listed below. Additionally, value indexes are more heavily weighted to energy versus growth indexes, and the energy sector finished down a staggering 32.2% for the year (Morningstar US Energy Sector). The growth indexes tend to have the largest weightings in the technology sector, which happened to be one of the strongest sectors for the year. While the consumer cyclical sector had the highest return for the year, driven by the large weighting in two stocks, Amazon (AMZN) and Tesla (TSLA), which, when combined, ended the year with a 33% weight in the index and up 76.3% and 743.4%, respectively.

						2020				
Morningstar Index Market Returns	2015	2016	2017	2018	2019	1st Qtr.	2nd Qtr.	3rd Qtr.	4th Qtr.	2020
Technology Sector	4.01%	14.06%	37.14%	-1.29%	46.66%	-12.27%	31.71%	11.82%	14.58%	48.04%
Healthcare Sector	7.13%	-3.44%	22.71%	5.91%	21.77%	-12.80%	15.86%	6.09%	9.53%	17.41%
Industrial Sector	-2.78%	18.71%	22.43%	-11.90%	31.40%	-27.47%	17.87%	10.98%	17.44%	11.44%
Consumer Cyclical Sector	6.29%	5.75%	24.47%	0.09%	27.25%	-22.03%	36.20%	20.12%	16.86%	49.07%
Consumer Defensive Sector	5.57%	7.02%	13.27%	-8.40%	27.51%	-14.00%	11.43%	10.81%	7.62%	14.28%
Financial Service Sector	-0.26%	20.63%	22.67%	-9.90%	33.37%	-29.53%	16.09%	4.76%	21.37%	4.02%

Outlook for 2021

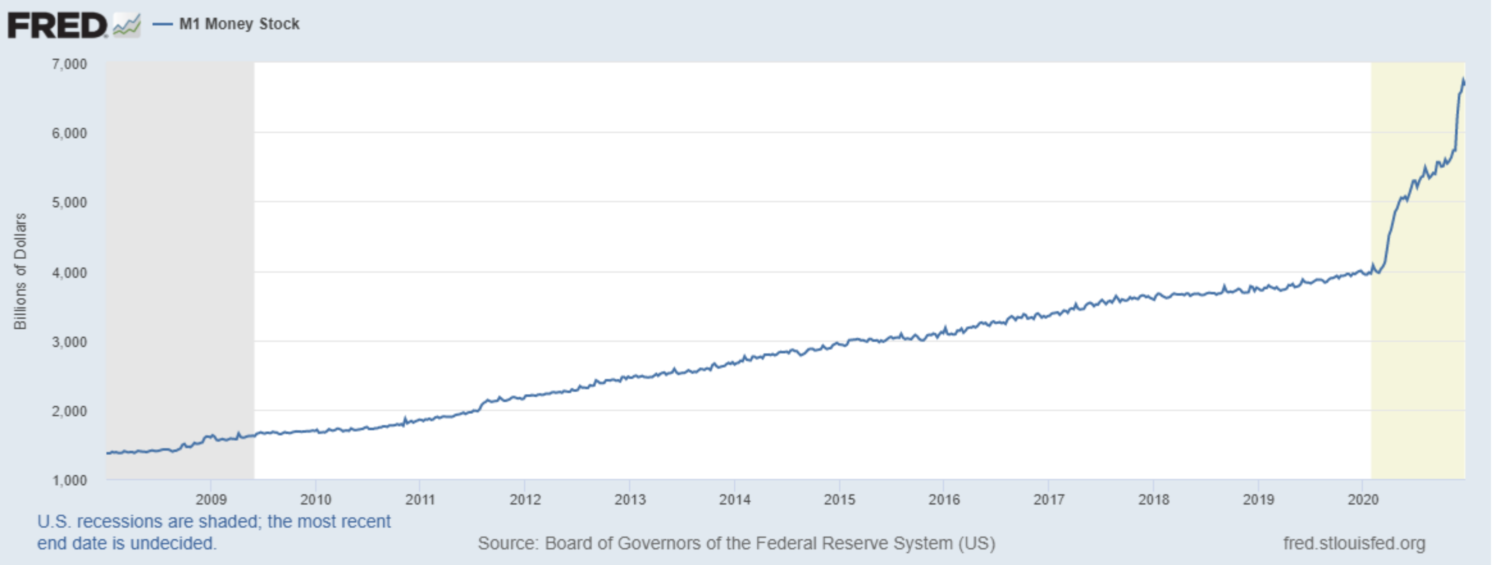
With that brief summary contextualizing where the market has been, we now lay out factors to establish probabilities for future market results. Though society has a fixation on measuring time by calendar years, current stock prices typically reflect a discounting measure of the future, depending on current conditions. A majority of the time, stock prices are discounting events six months into the future; so, in practicality, investment professionals are already discounting July 2021 and beyond timeframe into today's prices. This partly explains the public's confusion on how the stock market could be as strong as it was for 2020, and yet the economy appeared so weak, or at least as reported by the media (refer to the Maclura Investments mid-3rd quarter update).

Whenever there is great uncertainty, as seen in the early stages of the Covid-19 crisis in March 2020, investors reel in expectations and multiples (what investors are willing to pay for earnings) come down, resulting in stock prices declining. Once the panic selling had subsided and probability analysis on the fundamental prospects for companies began to be evaluated, the market resumed its upward climb.

Society enters 2021 with a clearing of the uncertainty fog, which is driving the stock market and the economy. Though the pandemic has had a profound, lasting impact on society, nonetheless, the longer the pandemic continues, the more each of us knows or experiences its impact. Not to minimize the real human tragedy of those that have been severely or fatally impacted by Covid-19, but a vast majority of the population recovers with minimal adverse symptoms. Once the vast majority of the population catches the virus and the unknown becomes known, behaviors could return to a more "normalized" threshold, particularly after the ongoing vaccination process works through the most susceptible of the population. Indeed, the light is at the end of the tunnel in regards to the pandemic. As "normalization" returns, pent-up demand for things put on hold in 2020 will become realized, driving the economy well into 2021 and beyond and providing a tailwind to stocks continuing to work in 2021.

The Covid pandemic not only had a profound impact on society, but companies that had been slowly adopting new technology and business practices into their business model to help drive margins higher had to abruptly adopt these changes to adapt to the new operating environment just to survive. To most companies' surprise, they could not only survive but thrive with the changes. After years in the investment industry, I am no longer surprised by the ingenuity of businesses to solve problems and adapt, and this is one of the reasons I give minimal consideration to political rhetoric that often faces specific industries. The significance of the rapid change in the business models resulting from the Covid crisis is that there is a tailwind for companies to have expanding operating margins by having every incremental dollar in sales contribute more in earnings than the previous dollar, which is a driver of stock prices over time.

Another factor to drive the stock market in 2021 is liquidity. The amount of capital put into the economy via monetary and fiscal policies in the past year is staggering to comprehend. The chart below is of the M1 money supply reported by the Federal Reserve. M1 are funds that are readily accessible for spending. Since the great recession (beginning of 2008), after 11 years of easy monetary policy, the M1 supply had increased $2.6 trillion dollars by the end of 2019. During 2020, the M1 supply has increased that same amount ($2.7 trillion).



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Since the Great Recession, the world's Central Banks have been desperately trying to get inflation into their economies to lift up the economy through "easy-money" monetary policies. The current environment reminds me of when I was an Oilfield Services Equity Research analyst for an investment firm following the offshore drilling industry. It was 1999, and crude prices had just hit $10 a barrel. I remember the date well; it was the first week of March 1999, and I have The Economist magazine from that week with the front cover featuring two roughnecks (oil field workers) covered with oil from a spouting oil well. The cover reads "Drowning in Oil." That publication marked the bottom of the crude oil market, and prices started their march upward to over $150 a barrel in 2008. Today, that publication could feature two bankers "Drowning in Cash" as the caption. Just like with oil, extremes are eventually fixed, and the pendulum swings to the other extreme, but with cash, there is no easy fix for that in the short-term.

With all this cash and with bonds not yielding an adequate return for investors until higher rates become a reality, the cash will likely find its way into the stock market. This has led to a very active initial public offering (IPO) market in 2020 as companies look to provide a home for all this cash. So much so, that during 2020, about 500 companies went public, which is the most since 1999. But most interesting is that nearly half of IPOs were Special Purpose Acquisition Companies (SPAC), also known as "blank check" companies. These are companies that raise capital before having an established operating business and use the capital to seek acquisitions for the benefit of their shareholders. The number of SPACs this year (248 in total) is four times the previous record. Private equity, SPACs, and companies are all looking for acquisition targets, running up multiples for targets that are in short supply.

The majority of clients with Maclura Investments have their portfolios in large to mid-sized growth companies with adequate diversification ranging from 65 to 75 holdings. Current small cap exposure (under $5 billion market cap) is less than 10% of the overall portfolio, dependent on the risk tolerance of each individual client. While the market has constantly supplied attractive investment opportunities for the past quarter, the Financial and Industrial sectors have been areas of new attractive investments.

With the debate of whether value or growth will lead in 2021, I vote for both, but selectively. I peruse the value indexes frequently searching for value cyclical growth companies poised to return back into favor as the economy strengthens. So it is not uncommon for Maclura clients to have holdings that are in "value indexes" but owned for the cyclical growth to come. An example of the type of companies falling into this category are two new investments that were added to client portfolios during the fourth quarter: Goldman Sachs (GS) and Moelis (MC). Both companies bring investment banking exposure to clients' portfolios, further diversifying their financial sector exposure from exchanges and information providers and are beneficiaries of the oncoming bolus of deals being driven by the excess cash in the system.

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While a tailwind awaits investors in 2021 and points to the probability of investment gains, there is always a possibility of a black swan event, as 2020 illustrated. The pandemic put a number of items on the back burner, such as negotiating the second part of the trade agreement with China. That will eventually return in focus, perhaps in late 2021. Political parties often establish goals and a framework of how the administration will move their agenda. With the Trump Administration, it painted an extremely bullish backdrop with deregulation and lower taxes driving the economy and improving the competitiveness of US-based businesses. The Biden Administration has been vocal about increasing taxes, but time will tell if that will be achievable or not with the narrowly split congress. There will be plenty of time to focus on the new administration's policy over the coming years, but the drivers laid out previously will be the core drivers of stock prices going forward in the near future.

In conclusion, 2021 looks bright, and it's exciting to see the opportunities unfold. Nonetheless, the recent market action towards the end of 2020 can illustrate that abrupt movements, both up and down, should be expected. During 2020, the S&P 500 had an intraday low on March 23rd, down 32% from the beginning of the year. Those that were overcome with the fear of uncertainty and sold their investments, lost out on the recovery as the S&P 500 returned 16.26% by the end of the year. Investing definitely teaches that patience is a virtue. There will be volatility in the future, but the overwhelming factors point to a market that should have double digit returns once more in 2021.

Maclura Investments, LLC is a registered investment advisor. Maclura Investments utilizes direct investing to build customized equity portfolios for individuals with as little as $100,000 to invest. For more info, go to MacluraInvestments.com

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