Quarterly Model Portfolio Update

October 12, 2020

U.S. Economy & Financial Market Observations

During the third quarter, both the S&P 500 and NASDAQ Composite notched all-time record high closes. Yet excitement sputtered in September as stocks slid for four weeks in a row amidst cooling enthusiasm for giant technology companies. Despite the September slide that saw the S&P give back about 6% from it's recent all-time closing high, it remains firmly entrenched in positive territory for 2020 with a 5.6% total YTD return through quarter-end. Other major equity indexes pale in comparison year-to-date, with domestic small-cap stocks still -8.7% and the MSCI International Index slipping -5.4%. In fixed income markets, the treasury-heavy U.S. Aggregate Bond Index gained 0.6% for the quarter to bring it's YTD return to 6.8%. Municipal Bonds and corporate high yield bonds also rebounded during the quarter, and now stand positive at +3.3% and +0.6% YTD[1].

The underlying dynamic of the S&P's 5.6% positive 2020 return, though, is one that bears some explanation and creates opportunity for a disciplined investment rebalancing approach. This year, most of those index gains were driven by just 5 mega-cap technology companies (Facebook, Apple, Amazon, Alphabet, Microsoft). Value-style stocks within the S&P have actually fallen about 11% while the "growthier" half of the S&P, deemed more pandemic-proof, and driven by that very narrow group of stocks has gained in excess of 20%. Think of the two halves of the S&P as a man standing with a leg in two buckets of water. One leg in ice water and one leg in boiling water, yet claiming, on average, to be at a comfortable temperature. This performance divergence within the S&P should certainly make investors, in fact, pretty uncomfortable. Recently, Vanguard's Investment Strategy group updated their forward-looking projection for asset class returns, with U.S. Growth Stocks now projected to return just 3.6% annually over the next 10 years while U.S. Value Stocks, despite recent under-performance, are projected to grow nearly twice that figure, at 7.0%[1].

While the growth versus value dynamic may be easy for some investors to overlook, the pending U.S. Elections are the headline issue that (though we might like to) simply cannot be ignored. Though historically, volatility has trended higher as elections near, it seems certain that absent a decisive victory, market drama will be pronounced and possibly acute in 2020. The prospect of a contested election is already showing up in futures markets for the CBOE Volatility Index with both December and January contract pricing unusually active and elevated. We do believe a decisive Biden victory – one that political betting markets have been projecting since early June – will not cause market roil. In fact, it may instead reassure markets that Democratic-leaning government stimulus will continue to be offered more readily to aid U.S. consumers through the pandemic.

Index Market Performance as of September 30, 2020	Year-to-Date % Total Return
S&P 500 Composite	5.57%
DJ Industrial Average	-0.91%
NASDAQ Composite	25.33%
S&P Mid-Cap 400	-8.62%
Russell 2000	8.69%
MSCI ACWI Ex U.S.	-5.44%
FTSE Emerging Markets	-2.09%
MSCI U.S. REIT	-17.86%
Barclays U.S. Aggregate Bond	6.79%
Barclays US Corporate High Yield	0.62%
Barclays Global Agg. Bond ($ hedged)	4.65%
Barclays Global Agg Bond (Unhedged)	5.72%
Barclays Municipal New York Exempt	2.05%
Barclays Municipal	3.33%
Bloomberg Commodity	-12.41%

(OVER)

Should President Trump rally from his sizable deficit in recent polls, markets at least would likely find solace in a continuation of his known, corporate-friendly tax policy. Unlike uncertainty, markets integrate both “good” and “bad” political news quickly – even if we may personally find that news distasteful or worse. An extended, contested election or civil unrest through December may exacerbate downside volatility. This is a possibility we need to be prepared for. Regardless of the duration of an unknown result, we would offer advance caution against any market timing or knee-jerk reactions. Instead, knowing that your portfolio is diversified appropriately to weather a storm and resting in the inevitability that it will pass is a diversified investor’s best ally.

Coming out of September’s volatility, investors should remain mindful that near record amounts of cash deposits held by both institutional and retail accounts may drive markets higher when uncertainty ultimately passes. With the Federal Reserve telegraphing near-zero interest rates through 2023, favorable valuations for stocks vs. bonds should prevail as rates stay low.

Current Portfolio Stance & Adjustments

NLFP Core Model Portfolios ended the quarter with YTD results ranging from +2.55 to -0.78%. The equity-only Core 98 model (-0.78%) carries substantial weights in international and smaller company stocks indexes that remain negative. However, we have started to observe positive relative returns in both of these assets classes as September’s volatility has served as a potential warning to over-concentrating in technology darlings. Meanwhile, all balanced Core Model Portfolios with exposure to investment grade bonds are now positive year-to-date led by the Core 30 at +2.55%.

When evaluating portfolio weightings at quarter end, the outsized returns of large cap growth stocks became a central theme relevant to our recent rebalancing activity. We believe the reason for outsized performance of a handful of large cap growth stocks vs. the average stock can be explained by “scarcity of earnings growth.” In the pandemic driven recession of 2020, quarter-over-quarter earnings growth has been virtually non-existent in most companies. Yet, even a modest economic turn around would end that trend quickly. If the economy picks up, investors should realize that a wider swath of companies are growing and have much more attractive valuations. This alone may continue to cause a substantial shift in sentiment[1].

In early October, we completed our 2nd model portfolio rebalance of the the year, following our March 9th addition to equities. Profits were harvested from Fidelity MSCI Information Technology Index (FTEC; +28.3% YTD) and Vanguard Growth Index (VUG; +25.8% YTD) and deployed across small cap, international and value index funds. Additionally, as part of re-truing portfolios to target stock allocations, between 2-4% of our fixed income weightings were shifted to more credit-sensitive fixed income funds from the iShares U.S. Aggregate Bond Index (AGG; +6.8% YTD.) As the economy continues to recover, such holdings offer more attractive current yields and potential for modest appreciation. As always, we believe our model portfolios should remain broadly diversified and strongly disciplined. 2020, in particular, has been the type of year that unpredictability within asset classes should allow our rebalancing methodology to contribute to ongoing strong, risk-adjusted returns. We encourage you to contact your advisor for information regarding your current portfolio holdings, performance or this most recent update.

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1. Investment index and NLFP portfolio performance data through 9/30/2020 is provided by Morningstar and believed to be accurate as of the date of this publication, gross of any advisory fees. Other sources include the Wall St. Journal, FactSet Research, Federal Reserve Economic Data (FRED) and the Vanguard Group. All investment strategies including diversified asset allocation have risk. Past performance of our investment approach, and component holdings does not guarantee future results. Advisory services are offered through NorthLanding Financial Partners, LLC, ("NLFP") Registered Investment Advisor. While all data is believed to be from reliable sources, accuracy and completeness are not guaranteed.