rebalance

Summer 2020

Something Happening Here

“There’s something happening here. What it is ain’t exactly clear…”
—“For What It’s Worth” Buffalo Springfield

As we reach the halfway point of 2020, we find ourselves reflecting on how much the world has changed this year due to the global coronavirus pandemic. Many Rebalance clients are concerned about the behavior of the stock market and ask, “How can the market be doing so well when the world seems to be falling apart? It makes no sense!”

One answer might be due to investor psychology. The legendary investor Sir John Templeton once made a statement that became widely quoted: “Bull markets are born on pessimism, grown on skepticism, mature on optimism, and die on euphoria.”

What Templeton is referring to is how investor psychology can drive market performance, especially in the short term. Pessimism, especially at the extremes, can be a perfect backdrop for market advances. Both extreme pessimism and extreme optimism tend to be fleeting. And each is hard to maintain.

Consider what happened right before this recent period of market growth. The stock market made new highs in February based on economic strength and investor optimism, followed by an economy placed on full stop in reaction to the coronavirus pandemic.

In a few weeks, euphoria and solid fundamentals gave way to extreme pessimism and uncertainty. Then the government responded with measures to help companies, employees, and markets. Extreme pessimism was slowly replaced with incremental optimism. Stock markets were starting to "climb the wall of worry" and recover. A stunning decline fueled by panic and uncertainty became the ideal set up for the current stock market advance.

A Tale of Two Cities

Short term, psychology often rules the market. Long-term, equity and bond markets tend to follow what investors call "fundamentals," such as projections of company earnings, inflation, and interest rates.

That is why it is important to look below the surface at what is going on inside markets to understand the recent stock market advance. It is critical to remember that "the market" is an average of prices of thousands of companies. And today the stock market is a tale of two cities. In the best of times companies facilitate working from home (WFH); in the worst of times those same companies suffer because people are required to social distance and "shelter in place."

The onset of the pandemic created the need for immediate social adjustments that caused a sharp decline in income for many businesses. Travel and leisure (airlines, hotels, restaurants), energy, and financial stocks have all suffered greatly as a result of the economic impact of people sheltering in place.

Cities become less attractive when bars and restaurants are closed. Companies need less real estate if there are fewer workers in offices. Consumer spending, after a shift to WFH, also seems to be changing — maybe permanently — and looks more like how one would spend during retirement. Apparel suddenly is less important than home improvement. Physical stores are even less relevant than they were before. When we are working from home we drive less, buy less gas, and put fewer miles on our cars.

US Equity Sectors and Returns — First Half of 2020

INDEX	S&P WEIGHT	3m TOTAL RETURN	YTD TOTAL RETURN
S&P 500 INDEX	100.0%	20.5%	-3.1%
S&P 500 INFO TECH INDEX	27.4%	30.5%	15.0%
S&P 500 CONS DISCRET INDEX	10.9%	32.9%	7.2%
S&P 500 ENERGY INDEX	2.8%	30.5%	-35.3%
S&P 500 HEALTH CARE INDEX	14.7%	13.6%	-0.8%
S&P 500 FINANCIALS INDEX	10.0%	12.2%	-23.6%
S&P 500 INDUSTRIALS INDEX	7.9%	17.0%	-14.6%
S&P 500 MATERIALS INDEX	2.5%	26.0%	-6.9%
S&P 500 REAL ESTATE INDEX	2.9%	13.2%	-8.5%
S&P 500 COMMUNICATION SERVICES	10.9%	20.0%	-0.3%
S&P 500 UTILITIES INDEX	3.1%	2.7%	-11.1%
S&P 500 CONS STAPLES INDEX	7.0%	8.1%	-5.7%

On the other hand, technology companies that facilitate working from home, and all that follows from this dramatic change in behavior, are seeing a financial windfall. It is estimated that prior to COVID-19, 15% of the workforce was WFH. Now 50% is WFH and ultimately, 30% post-crisis are likely to continue to WFH even after offices reopen.

The rise of technology companies is not a fluke but rather a reflection of the relative strength of these companies' earnings going forward versus other areas, such as energy, where there is clear fundamental deterioration. For the first half of 2020, technology was up 15%, while energy, financials (banks), and utilities were down -35.3%, -23.6%, and -11.1% respectively.

WFH requires updated computers, faster internet speeds, video conferencing software, better cameras, microphones, faster semiconductors, and an entire chain of vendors who will see increases in their earnings. Technology companies such as Amazon and Zoom surged because they benefit from changing behavior driven by the pandemic. Online retailers and delivery providers are thriving.

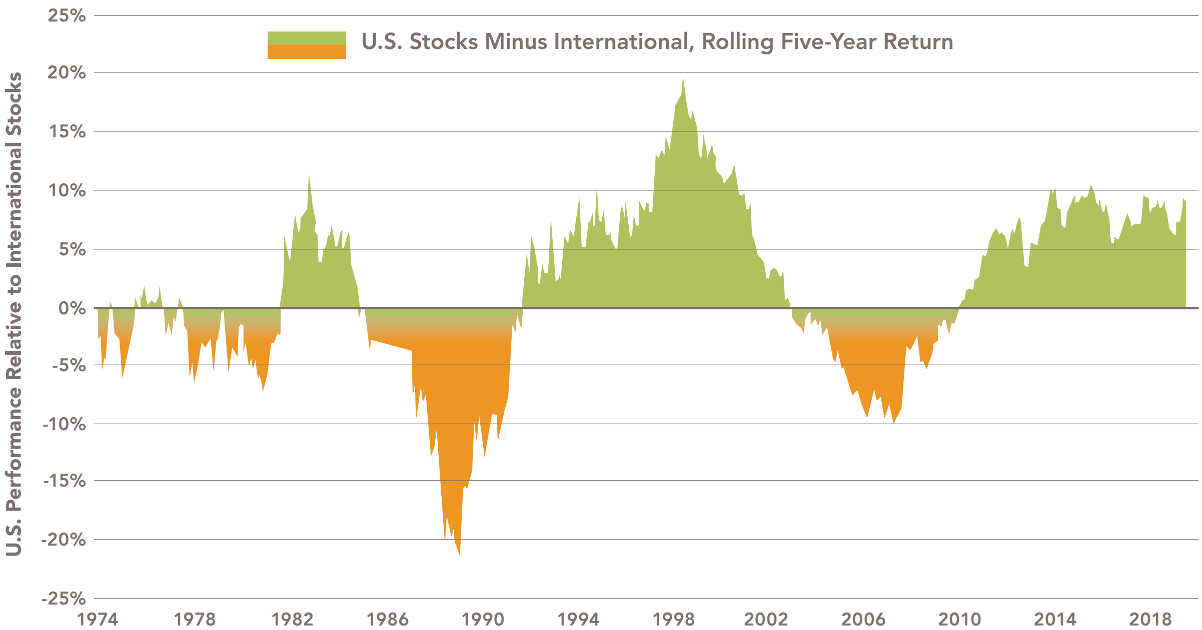
All Bases Covered

Your **Rebalance** index funds (ETFs) are weighted by the size (market value) of the underlying companies. This means that your portfolio naturally adjusts and favors leadership companies and industry groups that increase as a percent of the index, while laggard companies shrink in significance. The largest companies in the U.S. stock market are currently Microsoft, Apple, Amazon, Facebook and Alphabet (Google), all of whom are doing better fundamentally than travel and leisure-oriented and energy companies. The bigger they get, the more the overall index rises. That is why it is so important to hold index funds, especially during today's market.

Similarly, as different countries respond to the pandemic in different ways, leading to a variety of economic results, their role in the global economy can change. That is why it's critical for **Rebalance** investors to own international stocks in their portfolios, even though the U.S. has led global equities over the last several years.

International Equities vs. U.S. Equities

Rolling five-year returns (1970–2019) show that U.S. equities do, at times, underperform international stocks, reinforcing the benefits of a globally diversified portfolio.



Source: Bloomberg as of 6/30/2020. The graph shows the rolling five-year annualized total returns of the S&P 500® index, representing U.S. stocks, and MSCI EAFE® Index-Net of Taxes, representing International Stocks, from January 1970 through March 2020. The first rolling five-year period is January 1970 through December 1974. Returns assume reinvetment of dividends. Indices are unmanaged, do not incur fees or expenses, and cannot be invested in directly. **Past performance is no indication of future results.**

Rebalance clients participate in all stock market trends because they own a broad basket of stocks worldwide. These stocks may include small company and real estate stocks, high-dividend paying companies, and different kinds of income generating investments.

Rebalance portfolios are constructed for long-term investment success and not specifically for any given period. That means instead of shifting to a portfolio of 100% technology companies, we remain diversified instead of concentrated. Capitalization weighted indexes self-adjust to emphasize leadership companies. If trends normalize and energy companies rebound, those companies are in your portfolio. If the work from home trend stays in place for longer than expected, that would benefit our portfolios as well. That is why your **Rebalance** portfolio is surviving the COVID-19 pandemic and hopefully will continue to survive the next challenge and prosper in the future.

Please stay safe and healthy, and enjoy the rest of your summer.

World Markets Review – Second Quarter 2020

Index Returns

	US Stock Market	International Developed Stocks	Emerging Markets Stocks	Global Real Estate	US Bond Market	Global Bond Market ex US
Q2 2020	**Stocks**				**Bonds**	
	22.03%	15.34	18.08%	11.17%	2.90%	1.76%
Since Jan 2001						
Avg. Quarterly Return	2.1%	1.4%	2.7%	2.3%	1.2%	1.1%
Best Quarter	22.0% Q2 2009	25.9% Q2 2009	34.7% Q2 2009	32.3% Q3 2009	4.6% Q3 2001	4.6% Q4 2008
Worst Quarter	-22.8% Q4 2008	-23.3% Q4 2008	-27.6% Q4 2008	-36.1% Q4 2008	-3.0% Q4 2016	-2.7% Q2 2015

Past performance is not a guarantee of future results. Indices are not available for direct investment. Index performance does not reflect the expenses associated with the management of an actual portfolio. Market segment (index representation) as follows: US Stock Market (Russell 3000 Index), International Developed Stocks (MSCI World ex USA Index [net div.]), Emerging Markets (MSCI Emerging Markets Index [net div.]), Global Real Estate (S&P Global REIT Index [net div.]), US Bond Market (Bloomberg Barclays US Aggregate Bond Index), and Global Bond Market ex US (Bloomberg Barclays Global Aggregate ex-USD Bond Index [hedged to USD]).

The public policy response to the coronavirus pandemic caused an extreme economic shock and rapid stock market decline, followed by fiscal and monetary first aid in the form of liquidity (cash) injections from both the U.S. Government and Federal Reserve Bank. The U.S. stock market staged a significant rally during the second quarter fueled by investor optimism about the potential for economic recovery, low interest rates, and tremendous levels of stimulus out as far as the eye can see. International equities and both small and large-cap U.S. stocks rebounded from their March sell-off lows and led performance among global markets during the quarter. Some of the more conservative areas, such as investment grade bonds which performed well during the difficult markets in the spring, lagged during the second quarter. Rebalance portfolios generally benefited from exposure to stock market sectors that rebounded significantly during the quarter.

The **Rebalance** Investment Committee works with two broad asset classes as the basic building blocks of our client portfolios: Growth and Income. During the second quarter of 2020 these asset classes performed as follows:

Growth Asset Classes

Large U.S. Stocks. The jury is still out on the U.S. economy, and large company stocks experienced a "V-shaped" recovery during the second quarter. The fastest peak-to-bear market in history, sparked by the COVID-19 crisis, did a 180-degree turn and ended the second quarter in positive territory. Volatility was rampant and the sector performance perhaps uneven, yet a broadly diversified fund of large-cap stocks rewarded steady investors who failed to panic with the crowd. Aggressive Federal Reserve moves to provide credit wherever the market needed it helped, as did congressional action to provide direct aid to Americans in the form of stimulus cash and higher unemployment benefits.

Small Cap Stocks. Small cap stocks lagged behind large caps in performance. Small companies likely are more impacted by the response to the pandemic, generally are younger companies, and representative indexes don't have as high weighting of technology companies as their large-cap counterparts.

International Developed Stocks. Stocks of companies based in large foreign economies gained ground in the second quarter after taking a hit in the first. The virus was no respecter of international boundaries, of course, but some European and Asian countries fared better than others by mounting a rapid and effective response to the unfolding health crisis. While Germany and Australia shone, for instance, Hong Kong and the UK lagged.

Emerging Market Stocks. The impact of COVID-19 on emerging economies and companies was far more pronounced in some countries than others. Brazilian and Mexican stocks got hit with the double whammy of the virus and low commodity prices. South Korea, however, stood out as a shining example of how to manage a pandemic. China, while struggling early on, turned positive year-to-date despite being the first country to shut down portions of its economy in response to the emergency. U.S.-China trade tensions remained a negative factor, as did strained global logistics amid falling demand.

Real Estate. Massive government support for the financial markets extended to real estate investments, allowing those stocks to rebound along with stocks even as the number of property transactions fell sharply. Real estate operations that support technology companies by housing data centers benefited from the remote working boom. Other real estate sectors that held up include industrial and infrastructure properties, while lodging and retail took a hit.

Income Asset Classes

U.S. Government Bonds and TIPS. The Federal Reserve wasted no time and left no doubt among bond investors that it would support the credit markets come what may from COVID-19. The 10-year Treasury yield was relatively stable during the second quarter after falling in Q1. Inflation-protected government bonds (TIPS) outperformed the overall bond index despite little sign of inflation risk ahead.

U.S. Corporate Bonds. As the government moved to support credit markets, the supply of new investment grade corporate debt ballooned in the quarter, up 100% year-over-year. The Fed's backstop supported investor confidence. Bond prices went higher as yields fell, providing a double-digit gain in the second quarter following a negative performance in the three months prior.

High Yield Corporate Bonds. High-yield debt benefited from an unusual move by the Fed to back lower-grade corporate debt in response to the pandemic and ensuing shutdowns. Higher stock valuations and a rebound in oil fed into an increased level of investor optimism regarding economic recovery, leading to a better overall return for high yield in the second quarter compared to the first.

Emerging Market Bonds. Emerging market bonds rallied from a poor first quarter to post a solid gain in the second quarter on expectations that the worst of the global health crisis has passed as death rates decline despite a continuing rise in overall infections. A weaker dollar also played a role.

Preferred Stocks. A Federal Reserve move to cap common stock dividends was not extended to dividends paid by preferred stocks, a positive outcome for this income asset class. Meanwhile, the Fed found that all of the banks it chose to stress test were sufficiently capitalized, a good sign for preferred holders since banks that issue these investments are thus more likely to sustain their payments.

The Rebalance Investment Committee

The **Rebalance** Investment Committee meets several times a year to review our client portfolio options, asset class selections, and overall economic factors. The Committee's goal is to curate client portfolios that generate the most investment return for the least amount of risk.

During the April 2020 meeting, the **Rebalance** Investment Committee evaluated two longer term risks as a result of COVID-19 and addressed them in the most recent rebalancing in late April.

- In a world with near zero percent interest rates, the Investment Committee felt it important to seek alternative sources of income for our clients. In most portfolios, a high-yielding ETF was added with nearly 400 high-dividend paying stocks such as AT&T, Procter & Gamble, Intel, and JPMorgan Chase.
- Due to unprecedented amounts of monetary stimulus, renewed inflation is now a rising risk. As a result, in two of the growth portfolios, Treasury Inflation-Protected Securities (TIPS) have been added, which protects against rising inflation via an ETF collection of specialized U.S. Treasury bonds.

The Rebalance Investment Committee meeting in New York, April, 2019 (left to right: Scott Puritz, Charley Ellis, Jay Vivian, Burt Malkiel and Mitch Tuchman)

Rebalance and its clients are fortunate to have such respected and savvy financial experts guiding key investment decisions.

Professor Malkiel is an emeritus Princeton University economics professor, a former board member of The Vanguard Group, and the author of the investment classic *A Random Walk Down Wall Street*.

Dr. Ellis was for three decades the managing partner of Greenwich Associates, the leading strategic advisor and consultant to large institutional investors around the world. He was Chairman of the Investment Committee of the famed Yale Endowment, and he has served on the governing boards of The Vanguard Group, Yale, Harvard, NYU Stern, Exeter, the Whitehead Institute, and the Robert Wood Johnson Foundation.

Jay Vivian is the former Managing Director of the IBM Retirement Funds, responsible for over $100 billion in IBM investment funds for more than 400,000 employees worldwide.

We thank them for their input and wisdom.

Very truly yours,

Your **Rebalance** Team