rebalance

Summer 2021

"Silver Linings Playbook" Revisited

In the 2012 Academy Award-winning film "Silver Linings Playbook," Pat Solitano (played by Bradley Cooper) suddenly finds his world turned upside down. He will do anything for his life to go back to normal. Through a friendship with Tiffany Maxwell (played by Jennifer Lawrence), who is also engaged in some personal struggles, the two work together to find the "silver lining," the consoling or hopeful prospect in their respective situations, and help each other regain a sense of normality.

Similarly, in the aftermath of an unprecedented pandemic and lockdown it seems investors have been finding silver linings. Our world was turned upside down, with the unimaginable becoming commonplace: A seat on a Blue Origin space flight alongside company founder Jeff Bezos was recently auctioned off for $29.7 million. A piece of digitally created and certified original art (aka a non-fungible token or NFT) recently sold for $69 million. The artist, who goes by the moniker "Beeple", had never before sold a physical version of his art for more than $100. New asset categories such as cryptocurrencies are surging alongside difficult to comprehend "meme stocks." There is a sudden and significant shortage of goods, such as bicycles, shoes and cars.

As long-term investors, it's important to understand the significant forces behind major events and distinguish the permanent from the temporary, in order to identify the true silver linings.

Meme Stock Madness

We begin with the "meme stock" phenomenon. Perhaps you have heard of companies such as GameStop (brick-and-mortar retailer of video games and electronics), AMC Entertainment (media conglomerate, including movie theaters), Wendy's Company (fast food), Bed Bath & Beyond (housewares retailer) and Nokia (once a major force in mobile phones). These are companies whose stocks have been surging not because of their fundamental business success and attractive valuation, but rather because the opposite is true! The companies on this list are poorly thought of by Wall Street and heavily shorted by hedge funds, who are betting that the stocks will fall in value.

A group of "investors" who banded together via the online community Reddit have been buying shares of these stocks en masse, causing hedge funds to buy the same stocks in order to cover their short bet. Historically, we called this type of market action a "short squeeze," but because the buyers causing this squeeze united on social media, it is a new phenomenon.

Is a significant change taking place? Perhaps, but not likely. The continued rise of social media platforms are powerful for organizing groups of people. The Reddit meme stock community, however, is just a part of the broader market of buyers and sellers of stocks. While an interesting trend, investors who attempt to make money on the short side will start to factor online community bets such as this one into their positioning, likely lessening the opportunity for the meme-stock players. As index investors, we participate in these dynamics through exposure to small-capitalization stocks, which had a great run-up in the first quarter of this year.

Temporarily Out-of-Stock

In addition to the meme stocks, the financial headlines are full of stories of asset-price inflation and product shortages. Prices for existing homes, lumber, and used cars are up sharply. Much has been written about the significant forces pushing prices up, including increased housing demand from the "work from anywhere" movement, resulting from the exodus of working families leaving cities for more affordable suburbs and smaller towns. In addition, global supply chains were heavily disrupted during the pandemic, creating a significant shortage of goods just as pent-up, post-pandemic demand started to grow.

How concerned should we be about inflation? The Federal Reserve has deemed the current increase in some prices “transitory” because supply will eventually rise to meet demand. We tend to agree with this view. It may take some time for the supply of goods to return to normal given that many countries are still operating under the influence of Covid-19, so higher prices might persist into 2022.

Rebalance seeks to evaluate various types of investment risk and make sure that risk is covered. That’s why our portfolios contain securities which “inflate” as certain companies raise prices on goods and services, thus increasing their own earnings while benefiting shareholders and giving us as investors some protection from inflation.

Faster, Better, Cheaper

Finally, and most importantly, long-lasting changes are taking place in the way we live, work, and learn. Herein lies, in our opinion, the major silver lining of the Covid experience.

Growth in our economy and stock prices are driven primarily by increased worker productivity. Population growth helps, but having workers produce more of whatever it is in a day is what creates wealth. Increased productivity has always been a promise of the increased use of technology in the workplace. The ability to work remotely, powered by a raft of technology innovations, is proving to be an unprecedented productivity boost for workers and companies trying to produce the same amount of output at a reduced cost.

Remote teamwork, distance learning, and conducting client meetings via video conference were all happening before 2020. But, pre-lockdown, most companies relied on personal interaction first, complemented with digital interaction. The lockdown drove a grand experiment that helped us realize that digital interaction done right could be both very personal and incredibly enhancing in terms of productivity.

Working remotely might not be a full replacement for working in the office, but it has likely made the jump from one day per week to two to three days per week for many, and some workers will never return to an office.

Many knowledge workers no longer need to commute long distances every day, saving time, lowering stress, and enabling more affordable choices as to where to live and raise families. Companies will not need office space for 100% of their workforce and restaurants may serve more to-go meals, lessening the need for waiters. Productivity thus took a major leap forward thanks to the successful work from home experiment during the pandemic.

Outside of work we experienced improved telemedicine, accelerated vaccine development, online education and remote entertainment streaming. As with most major societal changes, there will be bumps in the road. For instance, gains in worker productivity may be somewhat offset in the near-term by increased input prices and a scarcity of finished goods.

But, over time, as transitory shortages normalize, we very likely will be left with higher worker productivity and other major positives, including less pressure on the environment and lower stress on workers, who can spend more time with their families.

The forces in place causing prices to rise appear temporary, while the productivity enhancing forces shaping how we live, work, and receive certain services appear permanent. All of this is a silver lining to a very difficult period and likely one reason the stock market continues to do well in 2021.

We hope that you, our clients, are finding joy in the return to a more normal world and in the impressive stock market returns we have experienced so far in 2021. We look forward with a long-term view, as always, and we wish you a fantastic summer.

World Markets Review

Second Quarter 2021

	US Stock Market	International Developed Stocks	Emerging Markets Stocks	Global Real Estate	US Bond Market	Global Bond Market ex US
Q2 2021	**Stocks**				**Bonds**	
	8.24%	5.65%	5.05%	10.17%	1.83%	0.35%
Since Jan 2001						
Avg. Quarterly Return	2.4%	1.7%	3.1%	2.5%	1.2%	1.1%
Best Quarter	22.0% Q2 2020	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% Q1 2020	-27.6% Q4 2008	-36.1% Q4 2008	-3.4% 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 **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 2021 these asset classes performed as follows:

Growth Asset Classes

Large U.S. Stocks. Large-capitalization company stocks outperformed their small- and mid-cap counterparts during a strong second quarter for global stocks. The United States continued to make progress on vaccination and reopening, resulting in improving company fundamentals. The fiscal and monetary picture also is supportive of stocks, including an infrastructure spending bill, a still-accommodative central bank, and falling long-term interest rates. The S&P 500 has now rallied for five months in a row.

Small Cap Stocks. Like large-company stocks, small-cap stocks rose in the quarter, driven by positive earnings news and a favorable macro backdrop. Although small-company stocks lagged larger companies in the quarter, they outperformed year-to-date.

International Developed Stocks. International stock indexes also surged in the second quarter as a sense of optimism broke out globally and Covid-related restrictions loosened.

Emerging Market Stocks. Emerging market stocks rose but slightly underperformed their developed international counterparts during the quarter. The emerging world is lagging a bit in terms of vaccinations and this may be showing up in their stock markets.

Real Estate. U.S. real estate companies continued their impressive 2021 performance with the best quarterly performance within the list of asset classes we track. The real estate sector is primed for fundamental improvement as offices, restaurants, shops, and hotels reopen.

Income Asset Classes

U.S. Government Bonds and TIPS. Higher quality government bond prices rose during the quarter as the inflation-driven rise in interest rates reversed course in Q2. The Federal Reserve's members said they feel that any inflationary increase near-term should be transitory, and the central bank also has begun to discuss reducing its accommodative stance in the future. Rates appeared to fall and bond prices rose based on the tenor of these comments.

U.S. Corporate Bonds. Investment-grade corporate bonds rose during the quarter based on the same dynamics influencing government bonds.

High Yield Corporate Bonds. Lower-quality corporate bond prices also rose in the quarter based on falling yields, improving corporate fundamentals and continued high demand for riskier assets.

Emerging Market Bonds. EM bonds also performed well in the quarter and got an extra boost from strong currencies.

Preferred Stocks. Preferred stocks are a hybrid security that combines characteristics of stocks and bonds. During the quarter the impact of falling rates was a positive for preferred stocks.

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.

At our April 2021 rebalancing we made slight modifications to our portfolios as per our committee's recommendations earlier that month. Our income portfolios, for investors seeking more of their total return from income and less volatility, we rebalanced toward more dividend-paying stocks both in the United States and internationally.

In the equities portion of our growth portfolios, we rebalanced between our funds to be more consistent with the global equity benchmark and to provide investors returns that come more from capital appreciation than income. For example:

- Emerging markets had grown to 12% of the benchmark from 8% last year, so we added exposure.
- Smaller company U.S. stocks had a large run-up since Covid, so it was an advantageous time to reduce our small-cap exposure and reallocate to the broad U.S. market.

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

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