T con Zero - Forty-fourth issue:

December 2020

More blackberry tart for 2021?

Notes about diversification and other market themes before the new year

I don't like self-referentiality, although the production of a regular series of notes sometimes makes it necessary. Today is one of those instances, because the literary reference to Agatha Christie's short story Four-and-twenty blackbirds I made in my last note of 2019 (T con Zero #32, Four-and-twenty blackbirds and 2020) is still relevant as we approach the new year.

In the story, a man who has never had blackberry cake at a restaurant he regularly goes to, on a particular evening orders it, along with other courses unusual for him. Detective Hercule Poirot says: "*You see, mon ami, where you went wrong was over your fundamental assumption.[...] A man under severe mental stress doesn't choose that time to do something that he's never done before. His reflexes just follow the track of least resistance. [...] A man who dislikes thick soup, suet pudding and blackberries suddenly orders all three one evening. You say, because he is thinking of something else. But I say that a man who has got something on his mind will order automatically the dish he has ordered most often before.*"

2020 has been a year in which I believe we were all under severe stress, as investors and most importantly as people. We had the pandemic, which is still ongoing. A contraction of global economic activity, provoked or exacerbated by the drastic containment measures of Covid-19 in many countries, seen only at the time of the world wars, and perhaps not even then. A collapse, between 26 February and 20 March, of most equity markets, that sent the S&P 500 into bear market territory, and dragged corporate and emerging bonds down into a sharp decline with few, if any, precedents. Then came a combination of enormous monetary and fiscal policy stimuli, which have fueled confidence in the economic recovery and improved prospects for financial markets. Since the beginning of April, the fastest and least interrupted recovery from a bear market took off, which brought the S&P 500 and Nasdaq back to new highs at the end of August and pulled up other markets, too.

Equity markets that seemed expensive at the beginning of the year may now seem even more expensive: the rebound from the bottom was driven by a valuation expansion, as the recession has demolished profits. On the other hand, expectations about earnings recovery are very positive and the aforementioned policy stimuli can contribute to justify them.

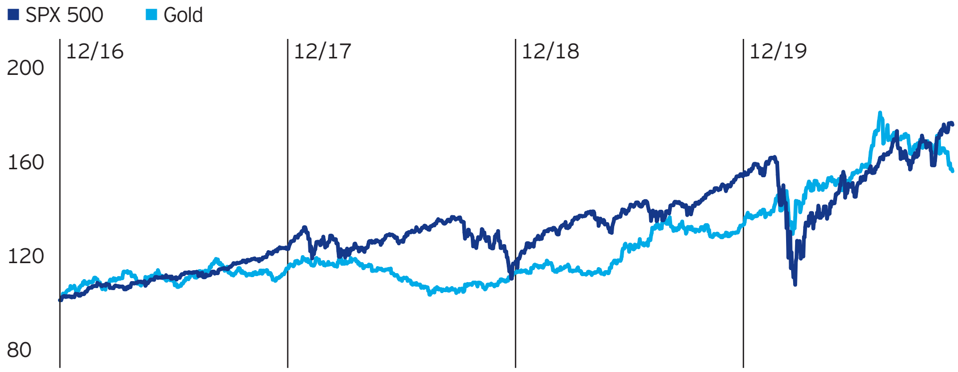
Blackberry tart in 2020? Actually, a lot of the usual courses.

In 2020 investors behaved in the usual way, albeit with some excesses. First of all, as I expected last year, they reverted to investing, even though households' accumulation of liquidity has continued.

The rest is history. The year of the markets started positively, following the 2019 momentum, with some hesitations due to strong performance valuations. When the pandemic came, people started franticly selling in the classic "sell first, ask questions later" style.

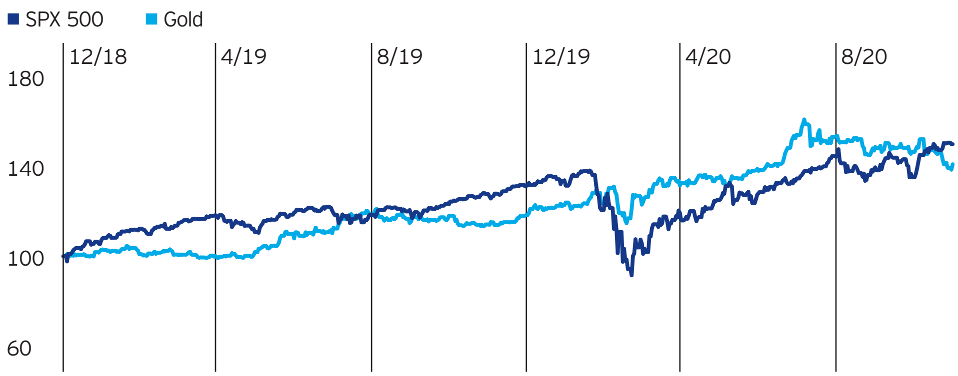
When, after a quick and deep collapse, investors came back to equity markets to buy, the themes and the stocks they chose were the same that had driven market performance in recent years, that is US equities, with a particular focus on technology and in particular on the six names FAANG + M. Investors also added gold, in an odd couple that has recorded synchronised rallies for almost all of 2019, but in reality beginning in 2017. Charts 1, 2 and 3 show the twin rallies of the S&P 500 and the gold bullion, and the S&P 500's valuation in terms of gold, which with the appreciation of the yellow metal in recent months has moved closer to the historical average (the higher the line rises above the horizontal one, the average in Chart 3, the more expensive the S&P 500 is in terms of gold, and vice versa).

Chart 1: Gold and S&P 500: "twin rallies", 2017-2020



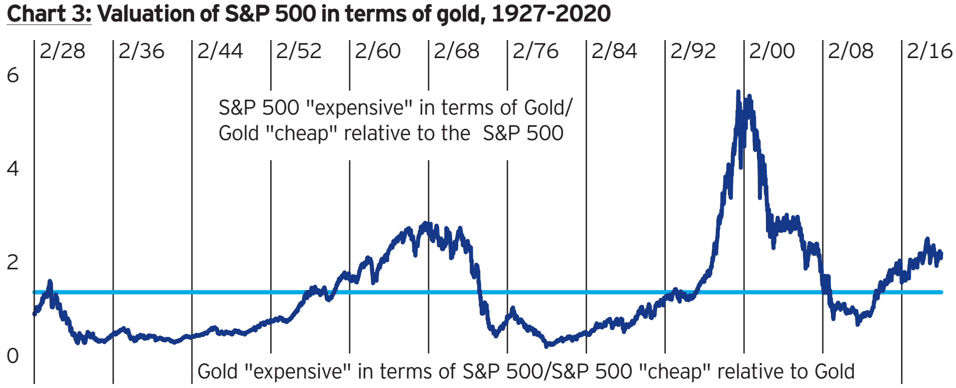
Source: Bloomberg, data from Dec. 31, 2016 to Nov. 30, 2020, in dollars. The return of the S&P 500 includes dividends. Past performance does not guarantee future performance.

Chart 2: Gold and S&P 500: "twin rallies", 2019-2020



Source: Bloomberg, data from Dec. 31, 2018 to Nov. 30, 2020, in dollars. The return of the S&P 500 includes dividends. Past performance does not guarantee future performance.

Chart 3: Valuation of S&P 500 in terms of gold, 1927-2020



Source: Bloomberg, data from Dec. 31, 1927 to Nov. 30, 2020.

In short, if we consider that, even in a world where there has been an continuous increase in liquidity accumulation, financial markets have maintained their tendency to rise in the long run, the infallible Hercule Poirot seems to have been right once again.

And in 2021, what could the path of least resistance be?

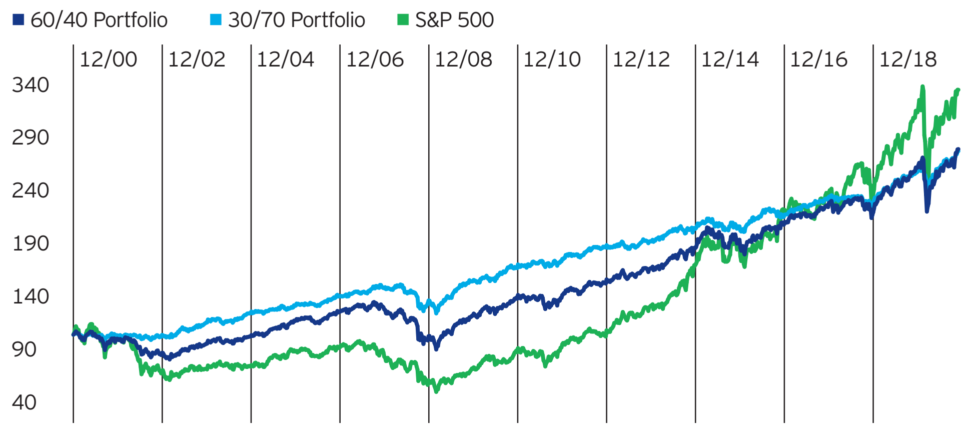
In 2019 and until early November 2020, investors who owned "well-diversified" portfolios lost opportunities compared to those who had a more concentrated exposure to the asset classes or securities that rose the most. In fact, this is always true, but lately it has been more true than usual, because market concentration has been higher than usual.

The question is: after the US presidential election and the announcement of some Covid-19 vaccines, now that we are seeing a rotation in favor of asset classes that have lagged recently, what makes sense for portfolios? Rotations between sectors, geographies, and asset classes have been the historical norm over the long haul. Can we consider the last few years, at least in part, as an exception, or are we really facing a new normal for the markets?

Diversification at work: not bad after all. And with decent prospects.

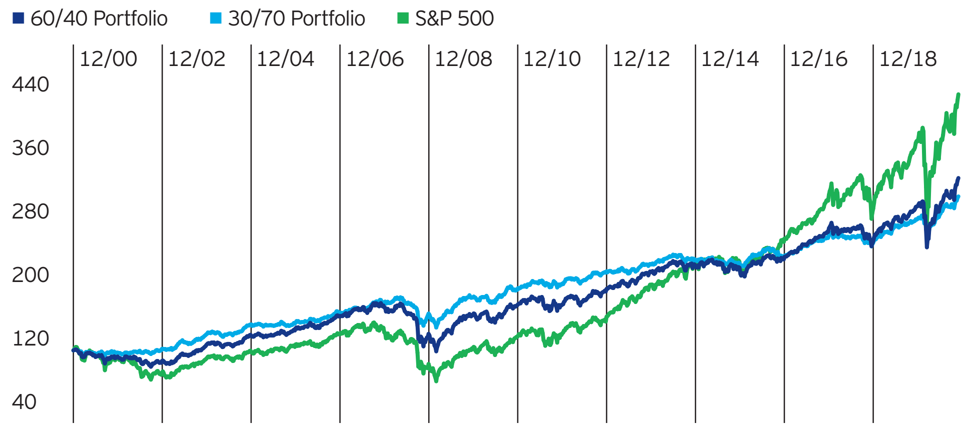
To answer this question we must first look at how diversified portfolios have performed. The answer is well. We take the classic 60/40 (60% global equities - MSCI World - and 40% global bonds – ICE BofA ML Global Broad Market), widely used in the financial industry, and a 30/70 (30% global equities - MSCI World - and 70% global bonds – ICE BofA ML Global Broad Market), which better reflects the historical preferences for some European savers. As charts 4, 5, 6 and 7 show, their total return performance in Euros was good. And even compared to one of the best performing indexes in the world, the S&P 500, over a 20- and 10- year period, the difference in performance is reasonable, especially when we take into consideration the much lower volatility of diversified portfolios. It is only not in, but in the time horizons starting in 2010 or 2015 when the performance gap has been really wide, that the effect of the better performance on efficiency - that is annualized performance divided by annualized volatility - neutralizes the higher risk profile of the S&P 500 (Table 1).

Chart 4a: Performance in comparison: portfolio 60/40, 30/70 and S&P 500: 2000-2020 (TR in Euro)



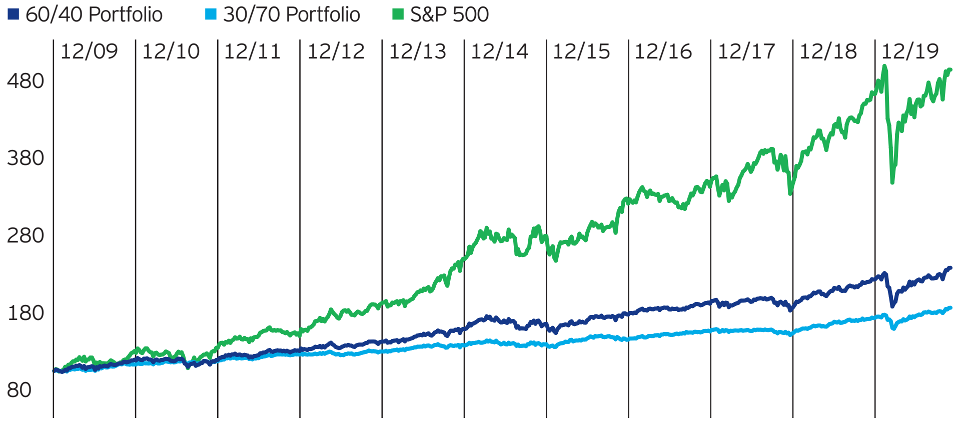
Source: Bloomberg, data from Dec. 31, 2000 to Nov. 30, 2020. All values are expressed in Euro and include dividends. Past performance is not a guarantee of future performance.

Chart 4b: Performance in comparison: Portfolio 60/40 vs 30/70 and S&P 500: 2000-2020 (TR in USD)



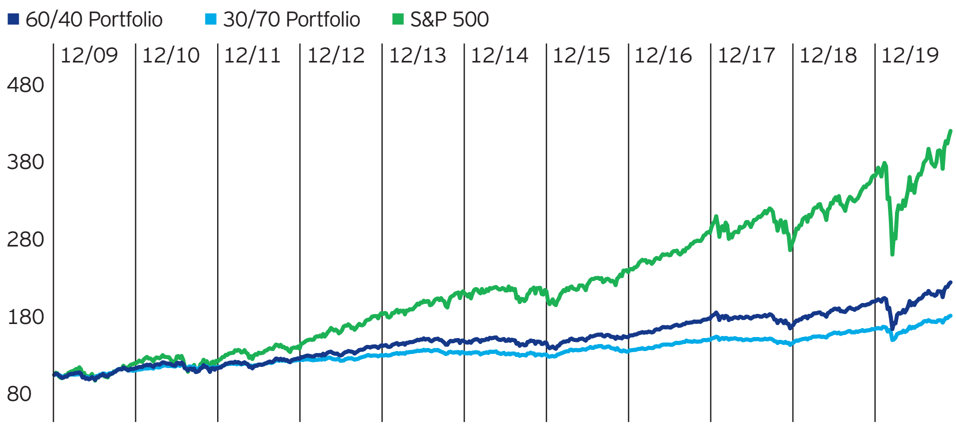
Source: Bloomberg, data from Dec. 31, 2000 to Nov. 30, 2020. All values are expressed in Euro and include dividends. Past performance is not a guarantee of future performance.

Chart 5a: Performance in comparison: portfolio 60/40, 30/70 and S&P 500: 2010-2020 (TR in Euro)



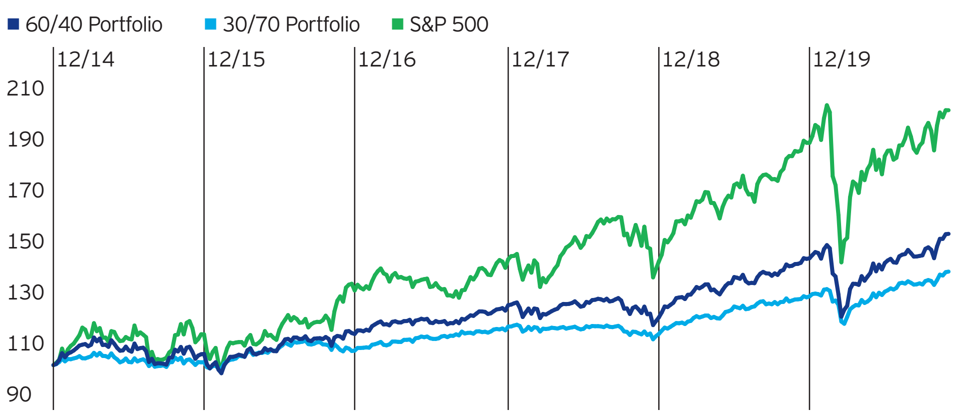
Source: Bloomberg, data from Dec. 31, 2009 to Nov. 30, 2020. All values are expressed in Euro and include dividends. Past performance is not a guarantee of future performance.

Chart 5b: Performance in comparison: Portfolio 60/40 vs 30/70 and S&P 500: 2010-2020 (TR in USD)



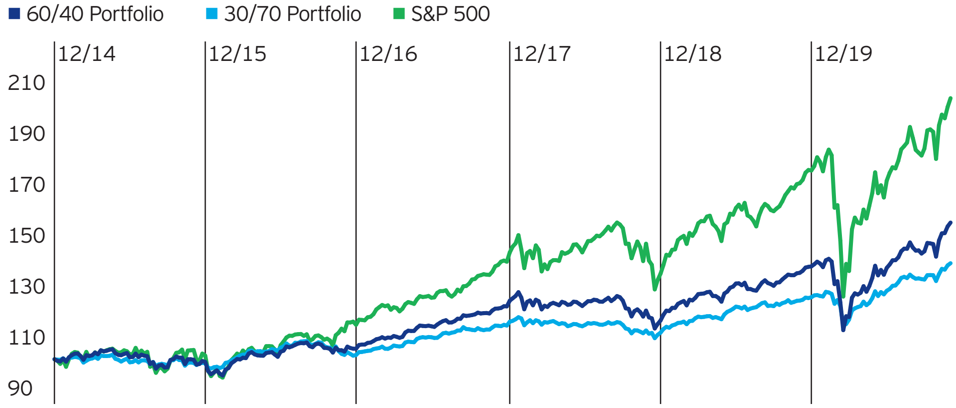
Source: Bloomberg, data from Dec. 31, 2009 to Nov. 30, 2020. All values are expressed in Euro and include dividends. Past performance is not a guarantee of future performance.

Chart 6a: Performance in comparison: portfolio 60/40, 30/70 and S&P 500: 2015-2020 (TR in Euro)



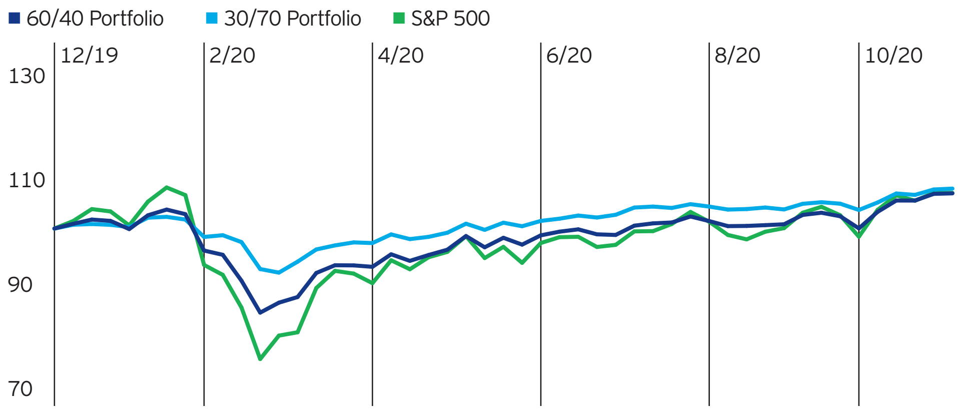
Source: Bloomberg, data from Dec. 31, 2014 to Nov. 30, 2020. All values are expressed in Euro and include dividends. Past performance is not a guarantee of future performance.

Chart 6b: Performance in comparison:Portfolio 60/40 vs 30/70 and S&P 500: 2015-2020 (TR in USD)



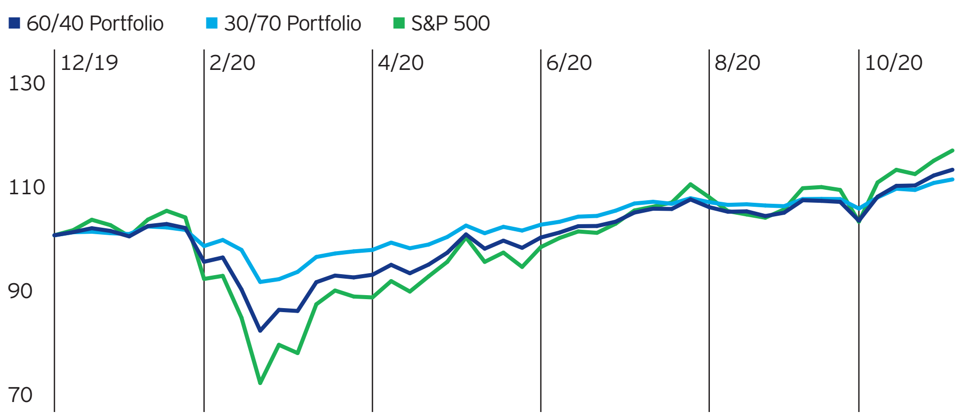
Source: Bloomberg, data from Dec. 31, 2014 to Nov. 30, 2020. All values are expressed in Euro and include dividends.
Past performance is not a guarantee of future performance.

Chart7a: Performance in comparison: portfolio 60/40, 30/70 and S&P 500: YTD 2020 (TR in Euro)



Source: Bloomberg, data from Dec. 31, 2019 to Nov. 30, 2020. All values are expressed in Euro and include dividends.
Past performance is not a guarantee of future performance.

Chart7b: Performance in comparison: Portfolio 60/40 vs 30/70 and S&P 500 YTD 2020 (TR in USD)



Source: Bloomberg, data from Dec. 31, 2019 to Nov. 30, 2020. All values are expressed in Euro and include dividends.
Past performance is not a guarantee of future performance.

Table 1: Performance and volatility compared: portfolio 60/40, 30/70 and S&P 500

		Cumulative Performance	Annualized Performance	Annualized Volatility	Efficiency*
Since 2000 (Total Return in Euro)	**60/40**	175.30%	5.19%	10.62%	0.49
	30/70	173.43%	5.16%	6.56%	0.79
	S&P 500	231.30%	6.17%	18.70%	0.33
Since 2010 (Total Return in Euro)	**60/40**	133.30%	8.84%	9.53%	0.93
	30/70	81.67%	6.15%	5.93%	1.04
	S&P 500	389.55%	17.21%	16.68%	1.03
Since 2015 (Total Return in Euro)	**60/40**	51.51%	4.24%	10.18%	0.42
	30/70	36.69%	3.17%	6.29%	0.5
	S&P 500	100.03%	7.18%	18.04%	0.4
YTD 2020 (Total Return in Euro)	**60/40**	6.76%	7.51%	16.14%	0.47
	30/70	7.67%	8.52%	9.51%	0.9
	S&P 500	6.85%	7.60%	28.77%	0.26

*Efficiency is calculated as annualized performance divided by annualized volatility.
Source: Bloomberg, data from Dec. 31, 2000 to Nov. 30, 2020. All values are expressed in Euro and include dividends.
Past performance and volatility are not a guarantee of future performance and volatility.

I also computed the same performance, volatility and risk-adjusted performance metrics for the diversified 60/40 and 30/70 portfolios and the S&P 500 in US Dollar terms, as we know many investors are US Dollar-based. The results are shown in table 2. The main difference between the two data sets is the effect of the Euro/Dollar exchange rate, which affects results in Euro terms.

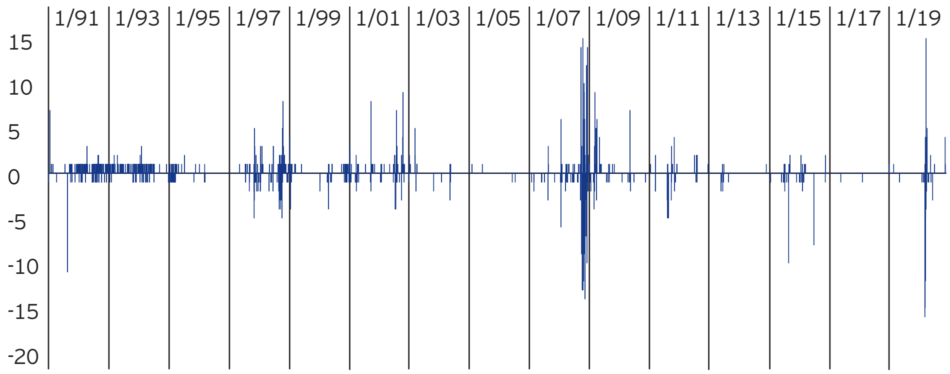
Table 2: Performance and volatility compared: portfolio 60/40, 30/70 and S&P 500

		Cumulative Performance	Annualized Performance	Annualized Volatility	Efficiency*
Since 2000 (Total Return in USD)	**60/40**	217.08%	5.94%	10.83%	0.55
	30/70	193.92%	5.54%	6.62%	0.84
	S&P 500	322.48%	7.47%	17.89%	0.42
Since 2010 (Total Return in USD)	**60/40**	119.65%	8.19%	9.86%	0.83
	30/70	76.52%	5.85%	5.98%	0.98
	S&P 500	315.50%	15.31%	16.37%	0.94
Since 2015 (Total Return in USD)	**60/40**	53.70%	4.39%	10.27%	0.43
	30/70	37.72%	3.25%	6.28%	0.52
	S&P 500	102.58%	7.32%	17.47%	0.42
YTD 2020 (Total Return in USD)	**60/40**	12.62%	14.05%	19.32%	0.73
	30/70	10.75%	11.96%	10.71%	1.12
	S&P 500	16.32%	18.21%	32.99%	0.55

*Efficiency is calculated as annualized performance divided by annualized volatility.
Source: Bloomberg, data from Dec. 31, 2000 to Nov. 30, 2020. All values are expressed in Euro and include dividends.
Past performance and volatility are not a guarantee of future performance and volatility.

There is more to it. We often correctly think - about diversification as a healthy guiding principle to manage and reduce the risk of our investment portfolios. The risk mitigating benefit is offset by the potential performance we give up. But diversification is actually useful also for seizing performance opportunities, especially at inflection points. A clear example of this took place on November 9th. Following Pfizer's announcement of an effective Covid-19 vaccine at around noon, European markets rose between 5% and 8% in a few hours. Even if equity investors know that they should have a long-term time horizon, it is clear that those who were not positioned in the European equity market before the announcement missed the material performance of that day. This is important because we know that equity markets' long-term trend is a rising one, and that even on a single day horizon, on average, stock markets historically rose in 52.6% of cases[1] (T con Zero #5). In recent years, there have been more frequent disorderly moves and the number of indices that, on the days of the greatest market swings, recorded changes higher than +5% and lower than -5% have increased, especially since the Great Financial Crisis, as shown in chart 8. Diversication helps to reduce the impact on portfolios during the most negative days, but also captures the most positive days.

Chart 8: Number of equity indices with daily changes above +5% or below -5% on a given day[2]



Source: Bloomberg, data from Jan. 1, 1991 to Nov. 30, 2020. All values are expressed in local currency, excluding dividends. Past performance is not a guarantee of future performance.

Similar reasoning applies to the rotation between growth and value, between large and small capitalization companies and between geographical areas. When Poirot talks about habitual behavior and paths of least resistance, for the investor there is a problem: what period is he exactly referring to? For example, market rotations have always been the norm. But not in the last three years, and in particular not in the last one. Good portfolio diversification can help us to not get lost in the labyrinth of this doubt.

Chart 9 shows that over the past three years the performance difference between the MSCI World's growth universe and the value bucket has been about 1200% (if the blue line rises, growth outperforms value and vice versa). In addition, most of this outperformance occurred in the last year. To make a historical comparison, it took about 26 years, from the end of 1980 to the beginning of 2007, for the MSCI World Value index, which historically has outperformed the growth part for most of the time, to exceed the performance of MSCI World Growth by a comparable margin.

Chart 9: MSCI World Growth and MSCI World Value, performance differential 1980-2020

Source: Bloomberg, data from Dec. 31, 1980 to Nov. 30, 2020. All values are expressed in local currency and include dividends. Past performance is not a guarantee of future performance.

Today the rotation from growth to value seems to have begun. I believe that it can continue, but that there are also structural reasons to think that some segments of the growth universe can continue to do well, and therefore it is not a forgone conclusion that the recent performance gap in favor of growth closes completely. However, its size is so large that even recovering half or a quarter of this gap can give a very material contribution to the performance of a portfolio. And we can reason along similar lines about performance differentials between some sectors and others. For those who do not feel comfortable taking on very pronounced positions, a diversified portfolio, even in terms of style, can be a sensible choice.

2020 is a year we will remember. We are approaching 2021 with some more important positive elements, including the recent news about vaccines to combat the pandemic. Still many elements of uncertainty remain. That is why I think diversification remains a useful ally.

A supplemental conclusion for historical statistics lovers, since 2020 has also been a US Presidential election year. On Jan 20, the US will inaugurate a new president, of a different party, after a single term, will face a change of President, of a different party, after a single term. Since World War II, this combination has only occurred twice. Once in 1980: Reagan, a Republican, succeeded to Carter, a Democrat, and then in 1992: Clinton, a Democrat, succeeded to Bush senior, a Republican. The relevant precedent for us today is the latter, with a Democrat going to the White House after a Republican, and the performance of the S&P 500 in 1993, the first year of Clinton's first term, was +7.06% in dollars, excluding dividends.

That is below the average of all the first years of the term of a Democratic President who replaced a Republican, which is +10.53% in US dollars, excluding dividends. Clearly still a positive figure to enter the new year with confidence in the markets and maybe take advantage of any weaknesses to accumulate equity positions in a disciplined way, always within a diversified portfolio.

Notes and references

Agatha Christie, Four-and-twenty blackbirds, 1940

T con Zero # 32, December 2019, Four-and-twenty blackbirds and 2020

T con Zero # 5, August 2017, Bolt Malaussène and equity markets (Italian version only)

1: For the details of the indices analysed and their respective starting years, see the list below. The final date of the analysis is November 30th, 2020.
Stock index % positive days
S&P 500 (since 1927) 52.4%
Europe Stoxx (since 1986) 53.0%
Topix (since 1949) 52.3%
Nikkei 225 (since 1970) 52.5%
MSCI EM (since 1987) 54.2%
MSCI World (since 1969) 53.0%
Euro Stoxx (since 1986) 53.1%
UK FTSE 100 (since 1983) 52.4%
France CAC 40 (since 1987) 51.6%
Germany DAX (since 1959) 51.8%
Nasdaq Comp (since 1971) 55.9%
FTSE Mib (since 1997) 52.1%
China CSI300 (since 2002) 52.6%
Spain IBEX (since 1987) 52.5%
Switzerland SMI (since 1988) 53.2%
MSCI Asia ex Japan (since 1987) 52.7%
Brazil (since 1989) 51.2%
Philippines (since 1987) 51.2%
Hong Kong (since 1964) 52.1%
Overall average 52.6%

2: The indices considered are: S&P 500 since 1927, Euro Stoxx since 1986, Stoxx 600 Europe since 1986, MSCI World since 1969 MSCI Emerging Markets since 1987, Nasdaq Composite since 1971, Nikkei 225 since 1970, Topix since 1949, CAC 40 since 1987, DAX since 1959, FTSE 100 UK since 1983, FTSE MIB since 1997, Ibex since 1983, SMI since 1988, Bovespa since 1989, CSI300 since 2002, Psei Philippines since 1987, MSCI Asia ex Japan since 1987, Hong Kong since 1964.

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