4Q 2020 Commentary

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Our disciplined investment process proved beneficial in 2020

At this time last year, our outlook for 2020 stated that portfolios were positioned for growth and that we expected the strong rally seen in 2019 to continue through the first half of 2020. Our view was driven by a favorable interest rate environment, reasonable earnings growth expectations, and a de-escalation of the trade war with China. Many investors missed out on the rally in 2019, and we thought they would return their capital to the market as positive momentum continued. This outlook seemed correct until late February, when the pandemic hit and the S&P 500 experienced the quickest meltdown in history, with a loss of 33.9%.

The Federal Reserve and Congress acted rapidly with enormous stimulus programs equal to roughly 40% of gross domestic product (GDP). Given this unprecedented level of support, the S&P began to price in a sharp recovery from the severe recession experienced in the first half of the year. We have now enjoyed one of the biggest rallies in decades, with the S&P 500 up 70% from March 23 through the end of the year.

Initial gains in this rally were led by technology stocks. Facebook, Apple, Amazon, Microsoft, and Google (FAAMG) all outperformed and reached new highs during 2020. These five companies now represent 23% of the S&P 500 Index. Last quarter, we highlighted this record-high concentration and noted the need for other industries to participate in order to keep the rebound going. We adjusted our exposure to FAAMG and used this as an opportunity to add equity exposure in the areas most affected by the pandemic and/or economic weakness. With two vaccines now approved for emergency use in the U.S., many of these names saw dramatic rebounds this quarter.

The S&P 500 Index gained 12.2% on a total return basis for the quarter to finish the year with a total return of 18.4%. The Technology sector led the way all year, while the Consumer Discretionary, Communication Services, and Materials sectors saw better performance in the second half (see Figure 1).

Figure 1

2020 Performance by Sector

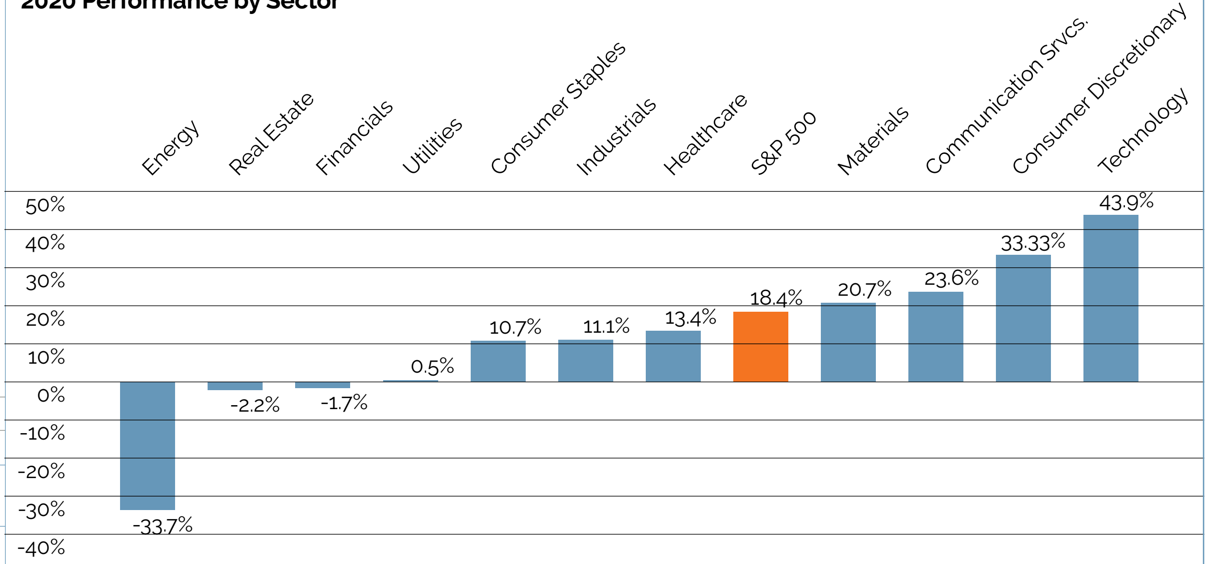

Figure 1 Source: Bloomberg. Data as of 12/31/20.

Inside

The Energy sector was the worst performer for the year, although many of the more economically focused sectors (Energy, Financials, and Industrials) saw strong outperformance after the vaccine approvals.

From a broader perspective, the S&P 500 outperformed most foreign markets this year (see Figure 2). When the returns of these foreign markets are expressed in U.S. dollars, as they are below, the differences are not as noticeable, since the dollar has been weak. This is part of the reason gold has been so strong. Crude oil was down more than 70% during the spring and finished the year down 21%.

Figure 2

2020 Performance by Category

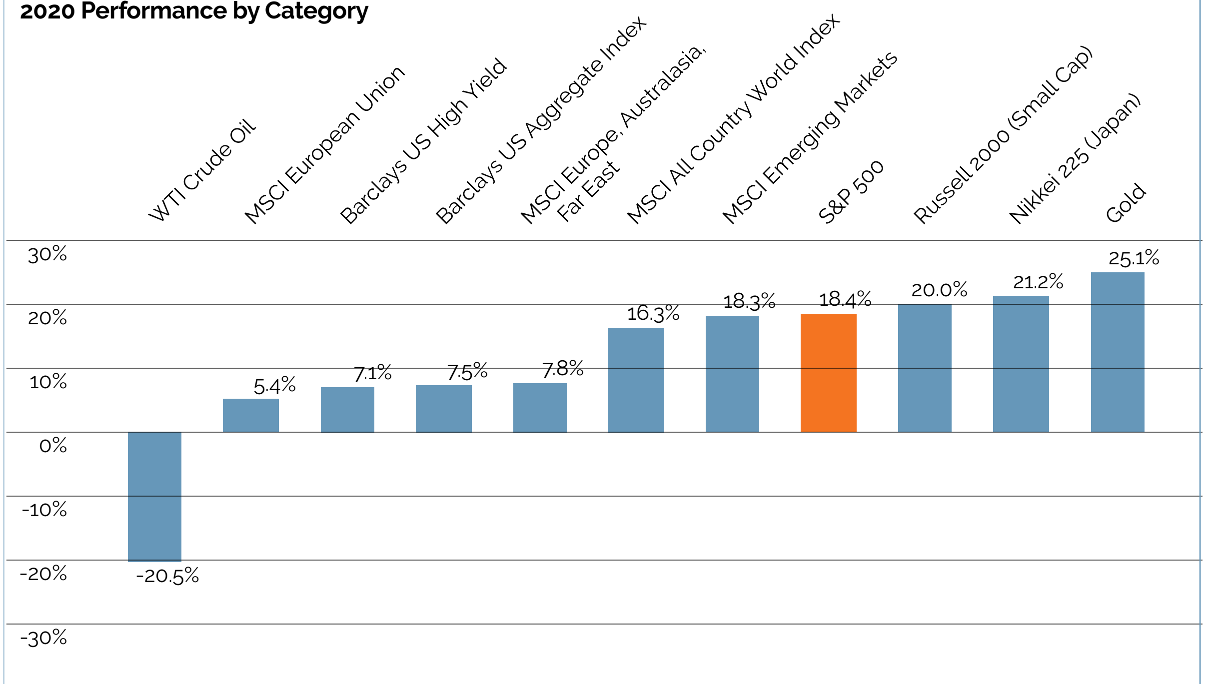

Figure 2 Source: Bloomberg. Data as of 12/31/20.

Outlook for 2021

If 2020 has taught us anything, it is that having a disciplined investment process in a rapidly changing environment is beneficial to your financial health. Our investment team did a tremendous job this year in adjusting to the situations we were presented with. The management teams for many of the companies we own also adapted quickly. The quality of management has always been an important component of our research process.

In general, the outlook for 2021 seems bright. Key fundamentals, such as GDP, consumer sentiment, and industrial production, continue to recover from the self-imposed recession we experienced in the first half of 2020. The Federal Reserve is expected to remain accommodative until the economy sees meaningful improvement. This environment should be supportive for stocks as artificially low interest rates further increase the attractiveness of equity returns.

With vaccinations beginning in mid-December, an end to the COVID-19 pandemic is on the horizon. As we move past these challenging events, we expect to see the consumer spend significantly more money on travel, leisure, and restaurants. The U.S. savings rate remains elevated and can provide dry powder to fuel the pent-up demand for discretionary goods and services. At the same time, we will soon have a new administration in Washington, DC, and the distribution of power will shift toward the Democrats. As we have mentioned in many previous Commentaries, over the last 30 years, stocks have experienced an average 14% annual correction. After such a strong rally, an average pullback would not come as a surprise. The current moment is an opportunistic environment for active management, supporting our constant effort to build positions in best-in-class companies at attractive valuations.

The Evolution of Retailing

In the first quarter of 2014, we wrote about the explosion of e-commerce. At the time, e-commerce penetration—a metric that captures online retail sales as a percentage of total retail sales—was 10% and expected to keep increasing. Retail concepts with strong brands were able to expand their physical footprints, while traditional brick-and-mortar retailers were showing signs of trouble. In the first quarter of 2017, we followed up on this theme. By then, the sector had entered a downward spiral, with thousands of stores expected to close despite a fairly healthy economy. Mall operators were looking to fill their space with more diverse tenants, such as climbing gyms, urgent care locations, and childcare centers.

This weakness continued into the following years, and our exposure to consumer-focused sectors remained guarded, as Amazon in particular and online retail in general caused disruption for many traditional retailers. E-commerce penetration expanded by a little more than 1% every year from 2012 to 2019, driven by behavioral changes and improvements in delivery. The COVID-19 pandemic and the resulting lockdowns and restrictions prompted consumers to order more things online—food, clothes, cars, toilet paper, masks. Initially this surge was likely due to safety precautions and sheer necessity. In the first quarter of 2020, e-commerce penetration increased by 5% (see Figure 3). This single-quarter increase is equivalent to four to five years of adoption at the rates seen in prior years. As you can see in Figure 3, e-commerce penetration is expected to accelerate from the level reached this year. This acceleration will benefit incumbents, such as Amazon, that have spent many years building defensible positions.

Research suggests that it takes 21 days to develop a new habit. It has been 289 days since New York City entered its first lockdown. While some people will revert back to their old in-person shopping habits, many will continue leveraging the newfound convenience of shopping online, and we believe these behavioral changes will be sustainable.

Figure 3

U.S. E-Commerce Penetration

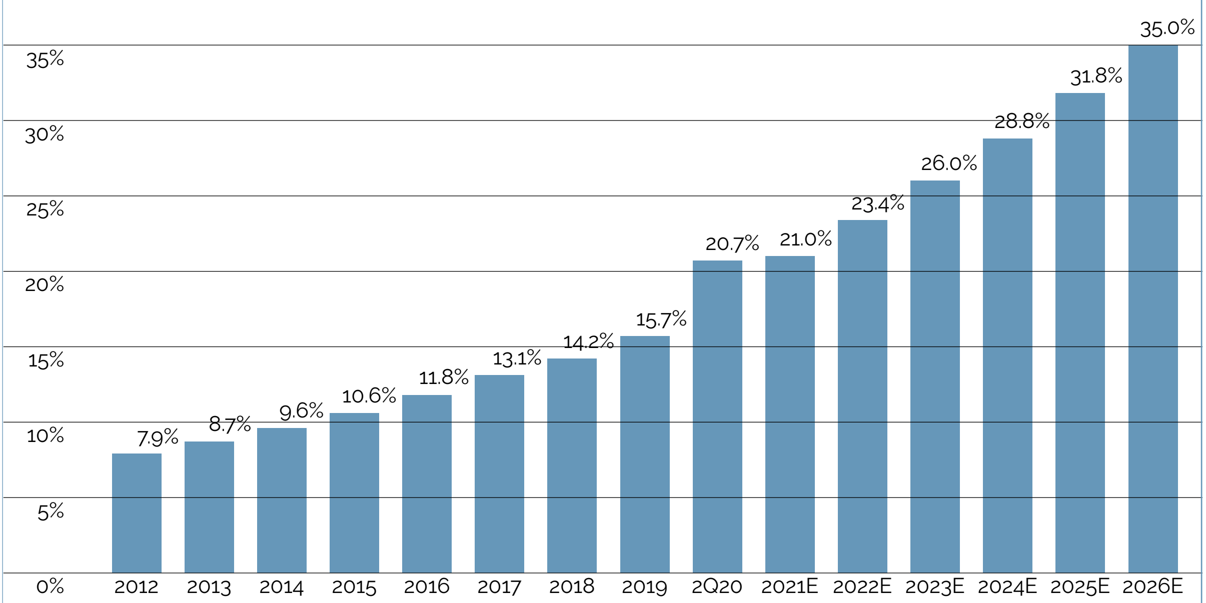

Figure 3 Source: US Department of Commerce and J.P. Morgan estimates.

Given that online purchases often require a credit card, this trend further accelerates the migration from cash to credit cards. To provide context, the U.S. and Europe combined see $26 trillion in transactions annually, of which around 70% are still done in cash. This market transition is a tremendous opportunity for credit card companies like Mastercard and Visa. Their payment infrastructure essentially provides the rails that allow digital transactions to move between businesses and consumers, consumers and consumers, and more recently, governments and consumers. Transaction volumes have now returned to pre-pandemic levels (see Figure 4). As government restrictions are eased and vaccines become more readily available, consumer spending habits will be driven by convenience. If you have received a new credit or debit card in the last 6 to 12 months, you may have noticed a new tap-to-pay logo on it. The tap-to-pay card will serve as a frictionless focal point for many methods of commerce going forward.

Figure 4

2020 U.S. Transaction Volume Growth

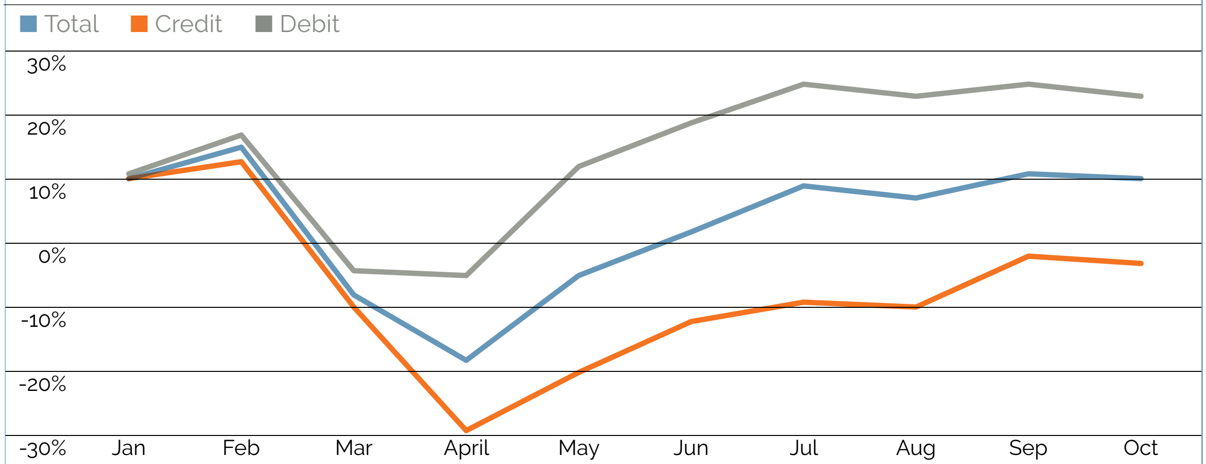

Figure 4 Source: Bloomberg and Visa Inc.

An Inflection Point for Technology Adoption

Imagine 2020 without the technology that we all have at our fingertips today—online retail, Zoom, DocuSign, remote working, and smartphones. The pandemic would have been a meaningfully more challenging scenario if it had occurred just 10 or 20 years ago. We have written over the years about the shift to cloud computing and software-as-a-service (SaaS) offerings. At a basic level, cloud computing means accessing data and services provided by a remote server owned and maintained by another party. With everyone operating online in 2020, these providers saw an explosion in demand. Software-as-a-service offerings are a natural outgrowth of cloud computing, with vendors delivering applications over the internet through service subscriptions. As with e-commerce, many users were forced to adopt these technologies even faster than expected, and we think this growth has long-term implications.

Throughout the pandemic, enterprises have been investing heavily in technologies like cloud computing and SaaS offerings. The integration of technology throughout an entire business and the shift of investment from servers to the cloud is referred to as Digital Transformation (DX). At the onset of the pandemic, Microsoft CEO Satya Nadella stated, “As COVID-19 impacts every aspect of our work and life, we have seen two years' worth of DX in two months.” Businesses have been forced to adopt remote technologies, such as Zoom's video conferencing, Slack's workflow platform, and Microsoft's cloud storage. Embracing DX has helped many businesses overcome near-term tragedy, all the while getting an immediate payback from their investment.

At a recent investor day, Salesforce.com highlighted that in 2022, global DX spending will equal all other IT spending (see Figure 5). Prior to the events that unfolded this year, the estimated break-even point between DX spending and other IT spending was 2024. In summary, companies of all sizes are pushing forward their timetables for digital transformation spending. We expect this trend to continue for years to come and are appropriately investing for this long-term secular change.

Figure 5

Worldwide DX Spending vs. Other IT Spending ($ trillions)

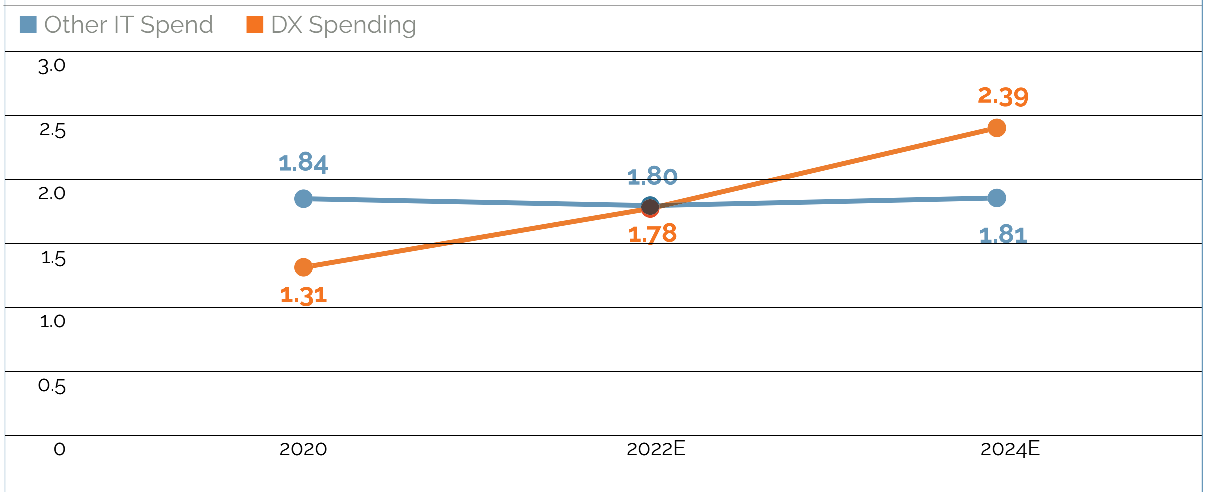

Figure 5 Source: IDC Worldwide Digital Transformation Spending Guide, November 2020 (V2 2020).

Course of Action

Last quarter we highlighted our additional equity exposure in the areas most affected by the pandemic and/or economic weakness. Many of these industries fall into the "value" category of investments. We noted the record-high concentration of the top five stocks in the S&P 500, which all fall into the "growth" category. For the market to move higher, we expected we would need to see greater participation from value companies as the market began to price in the end of the pandemic. With the FDA approval of two vaccines, this "rotation" finally came, and we saw some new industry leadership. The S&P 500 Value Index (SVX) dramatically underperformed the S&P 500 Growth Index (SGX) for much of the year, but this pattern reversed during the fourth quarter.

During the quarter, we added to our equity exposure in these value categories, including the Energy and Financial sectors, both of which are cyclical in nature and will benefit from a reopening economy. At the same time, we continue to monitor our exposure to the five largest companies in the S&P 500 to manage risk in this area. We expect market participation to keep broadening in the next 12–18 months and are being opportunistic in adjusting portfolios accordingly.

This passing of the baton to new industry leadership may be a bumpy process, and we have sized positions to take this expectation into account. We reduced our position in the Healthcare sector and adjusted exposures in the consumer-focused sectors, where disruption remains a pervasive theme. We continue to be very selective in these areas, but many of these names will benefit as the economy recovers.

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