The Market Rotation of 2020 - Transcript

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Tom Mullooly: Welcome back to the podcast. This is episode number 340. I am Tom Mullooly, and I'm joined today by Brendan Mullooly and Tim Mullooly. Hey, guys.

Tim Mullooly: Hey.

Brendan M: Hello.

Tom Mullooly: So Tim, we have to talk about quilting today.

Tim Mullooly: Right, so the beginning of every year for the last handful of years, Ben Carlson at Ritholtz Health Management puts out his performance quilt, where he lists a handful of different asset classes and shows how they performed over the years. He just put out his one for 2020, since we have all the data and all the numbers from 2020. And it's always interesting to see the randomness or the different assortment of where the different asset classes line up. An interesting point to lead off with is that, this is the second year in a row in 2020 that large caps were at the top of the list. But going back to 2011, they hadn't been number one for the rest of that decade. So it was two in a row and then they weren't in the top spot at all. It kind of just shows how it's hard to predict what's coming next.

Tom Mullooly: It really does look like a patchwork quilt. They do each different style group in color. So when you look at it at first glance, it really does look like a quilt, because there's different colors all over the place, patches everywhere. But that really does drive the point home that you can't just say, "I'm just going to buy a blue chip portfolio with dividends and just let it rip."

Brendan M: Yeah, I think the message is that nobody stays at the top forever. And in most cases, in fact, if you do see a stretch of an asset class at the top of the list for a year, two, or three, it's normally followed by them being in the basement after that. And so if you're trying to go all in on what has worked, I think you're going to be disappointed on a go-forward basis, especially if we're looking one, two, three years into the future. You can't just pile into what's en vogue now. That's not a strategy for success.

Tom Mullooly: So I know that we've talked about this a couple of times over the years, but forgive me for being the broken record in the group. Emerging markets were on fire. Now, I'm dating myself, because this was 2004 and 2005. I received more unsolicited calls from clients asking for us to put money into emerging markets in 2006 than any other time before or since in my career. And 2006, '07, '08, '09, I've lost count emerging markets were in the cellar exactly as

you just described for the next several years. And so reading, Barron's and some of these other financial mags that tell you this sector is hot, is almost a cell signal.

Tim Mullooly: It could be also, I think a good point to make is that some years being what we've described as in the cellar or last place on this performance quilt, doesn't necessarily mean that it was a bad place to be. It just means that the other areas performed better. So in 2020, there's 11, including cash, there's 11 different groups listed on this quilt. Nine of the 11 were in positive territory. So you could be towards the bottom of the performance quilt in terms of how you did last year, but it doesn't necessarily mean that you lost money in those investments. It just means that they might not have gone up as much as large caps who were in first place. But it's interesting to note that in a year like 2020, nine out of 11 areas of the market that he talks about here were positive.

Tom Mullooly: So Brendan, does it make sense to try and move your money around into these sectors as they're at or approaching the top?

Brendan M: No, I don't think you should ever allocate money based on recent performance. I think that's a very bad way to put money to work. I think that if you had something that was towards the bottom of this list last year, or maybe even the last two years, probably a good signal that your patience will be rewarded. And probably sooner rather than later. And you almost certainly regret taking money out of that to pile into whatever was at the top. I think that's buy high, sell low. That's the opposite of what we're trying to do as investors. I also thought it was interesting on the chart that you look at 2020 as a year where like everything worked kind of. Meaning like most of these things were positive to varying degrees, but they were all places that made money last year.

I mean, even government bonds or the aggregate bonded actually made like six or 7%, which is insane considering where we started from and how much of that was comprised of yields, maybe one or 2% capital appreciation.

Tim Mullooly: Considering all talk that we heard throughout the year about how you shouldn't be in bonds or why own bonds. If interest rates and yields are this low …

Brendan M: It's been a decade, now people saying bond yields can't go any lower. Like if you have money in bonds, you're going to lose money, this is terrible. You can't do this and it's been dead wrong for a decade. So I don't want to hear it anymore. Interest rates are super low. I think you need to understand that. And the dynamic that it creates in your portfolio in terms of how allocate to it. But I'm tired of hearing the doomsday predictions for people who want to have some portion of their money in bonds. There's probably a good reason for that if they have a financial plan.

Tom Mullooly: And so I think people tend to forget one part of the picture that tends to get overlooked is what kind of inflation is out there in the system. If there's a lot of inflation, we're probably going to see rates hopefully at, or above the rate of inflation. If there's no inflation in the system, which is pretty much what we've been working our way through for eight or nine years now. You shouldn't expect rates to return much of anything. We've talked about this now

several times on the podcast that we, we don't necessarily buy bonds for clients for the yield, buy them more as a bumper to help smooth out the volatility in the markets.

Brendan M: Right, and they're not an inflation hedge either. That's the stocks out of the portfolios. So inflation can do whatever. And I still don't know that that makes bonds a bad investment. But looking like … so 2020 everything worked. And if you look at 2019 on this chart, basically everything worked too, not that past has to be prologue or anything. But in terms of setting expectations, the last time on this chart that we had two years in a row where everything worked, were 2016 and 2017. And then the following year, the top performing asset class on that chart was cash. So just saying that like after two very good years in the market, not without volatility, obviously aware of what happens roughly nine months ago now, the market went berserk and was down 30%.

So you can't discount that that happened. It didn't fit neatly into a calendar year. So you don't see it at the end of year return numbers because of the recovery. But we can't just continuously have years where everything works and there's going to be volatility. And it's not because of anything specific, you're looking at two years, like 2016 and '17 that are very different than 2019 and 2020. I mean, what year was like 2020?

Tom Mullooly: I can't think of one.

Brendan M: Right. And so in 2018, wasn't a super great year for stocks and the draw down in then happened to happen right at the end of the year. So performance numbers didn't look great on a year over year basis then. I guess I'm more getting at the idea that like, there wasn't anything specific in the news or the headlines or politics that made that a bad year to invest.

In fact, it was fine for most of the year. And then at the end of the year, there was a brief draw down, which we recovered in 2019. So I'm just saying like, this year could be a rough year for stocks, it may not be. And if it's a rough year for stocks, it's not because of anything specific that we can put our finger on now.

Tim Mullooly: I mean, like if you 2018, these two examples, like last year and then 2018 and put them side by side and compare like, okay, outside of the market, the headlines and everything that was going on. What happened in these two years? And then ask someone, "Which year do you think the market did better?" And people are going to look at the headlines, what happened in 2020 and my guess is the most people will be like, Oh, I think stocks did better in 2018 relative to what happened last year. It seemed pretty calm.

Brendan M: Right, so you're saying if you like listed out all the news items…

Tim Mullooly: Here what happened in 2020 this, this, this, this. Here's what happened in 2018, this, this, this.

Brendan M: Which one do you want to invest in?

Tim Mullooly: Exactly.

Brendan M: 2018, for sure. And you would end up losing money as a stock investor that year and making very good money in 2020. So great point Tim.

Tim Mullooly: Yeah, kind of going along with this and like what's worked versus people's perception of what's working. Michael Batnick also at Ritholtz Wealth Management had a post this week titled Rotation. And he was talking about, he calls them the FANMAG, some people call them FAANG, but you add a couple of stocks in there, and it's a comprised of Facebook, Apple, Netflix, Microsoft, Amazon, Google, just the giant tech names that everyone associates the big tech stocks with. I bet if you were to ask people which stocks did the best in 2020, or over the last handful of months, people would probably anticipate that like Amazon and Google and because of the shutdown-

Tom Mullooly: Everyone stayed home and shopped online. Amazon did great.

Brendan M: Big tech is propping up the market and all of these gains and the recovery. You have to be in large caps and technology to make any money. I mean, that was the narrative coming out of the drop that we saw in February, March of last year. The whole recovery April, May, June was if you weren't in tech stocks and large cap stocks, then you weren't making any money.

Tim Mullooly: And we fielded calls from people about wanting to put their entire accounts into Amazon or into like one specific technology stock name. And so Michael took a look at just over the last six months relative to the rest of the stocks in the S&P 500, how have these done? And besides Apple, the other five stocks, Google, Facebook, Microsoft, Netflix, Amazon, they all underperformed the rest of the S&P 500 index. So Amazon was 455th out of the S&P 500. So it's only 51 stocks or roughly 50 stocks in the S&P 500 did worse than Amazon over the last six months.

Brendan M: So if you took the general narrative over the summer of, hey, I have to be in large cap in tech, if I want to make any money and piled into all that stuff and sold that or whatever you were coming from. That ended up being about the worst time to do that, that you could have picked.

Tom Mullooly: Well also fielded a few calls from folks late in the summer who questioned, why do we have these small cap and mid cap indices in our portfolio? They haven't done, I won't say what they said, but they haven't done anything. When we got those calls, it was almost within that week when somebody lit the fuse in these other stocks.

Brendan M: I have some numbers to that incorporate international, which I would throw into that bucket as people have complained about international stocks for years on end. Since September, so through the fourth quarter of the year, international develop markets and emerging markets have both outperformed the S&P 500 by six and 9% respectively. So chuck that narrative out the window.

Again, at the time you want to throw in the towel or you've had enough of the under-performance from an asset class, it proves you wrong. It's also interesting to note that since the

fourth quarter of 2020, small cap stocks outperformed the S&P 500 by 24% and their mid cap counterparts were not far behind. And so to your point, small caps, mid caps, international, basically everything except US large cap since the end of the summer has been a better place to be than what the narrative at the time would have told you. And interestingly enough, especially with small caps, you saw the US dollar over that same time period, down 2%. And normally people would predict that that would be a negative for small cap stocks, which are supposed to do well when the dollar is strong. So nobody knows nothing, right?

Tom Mullooly: That is the answer.

Brendan M: Take all of the textbook stuff about like what's supposed to work and when, and Chuck it out the window. Or at least admit that we don't know for sure, so we have to have some money in all of these different areas, in appropriate amounts. Because we can't predict, especially over three months, six month periods or year long periods, what's going to be the best place to be. And by the time we know it's too late.

Tim Mullooly: Yeah. It doesn't mean the big tech stocks that we were just talking about. That doesn't mean sell out of them and pile into small caps or anything like that. But like you said, it just proves why you should have a mix of all of them. I mean, Batnick had similar statistics, the six tech stocks he was talking about were up 7% over that time. SPY, which is the S&P 500 was up 17%. And IWM, which is the Russell 2000, which is small cap stocks is up 45%. So all of them were positive though. It doesn't mean going back to one of the first things I said, it doesn't mean that, it was a bad place to be. It just means there was potentially, there were better places to be. But like you said, we don't know when they're going to shift.

Tom Mullooly: We have to be aware of, I brought with me into the conference room, the first two pages of this week's Barrons. Just to kind of show how the news publications surrounding our industry can, they're not intentionally misleading, but they're reporting what has happened and not what will happen. So they talk about how game stop is missing the mark. Now, we don't typically talk about individual stocks, but they said, the run-up in the retailer stock belies a sharp drop in sales and malls where their stores are, are losing appeal. And that stock has just continued to move higher. We're not recommending game stock, but it's just to show you the perception that's out there may be wrong. They also talk about how some of the old stocks are still hanging in there. And they mentioned US steel and general electric, which have not been good investments for fill in the blank period of time, a long time. Then they talk about how the risks are rising for big tech names. Well, we just showed that that would have been a great headline to have in September …

Brendan M: July.

Tom Mullooly: Not necessarily … Yeah, so …

Brendan M: Like your point is, they're not writing feature articles about what's going to work there. They're writing feature articles about what has already happened. That's the only thing they can do to defend them a little bit. Like you don't write a feature article about this asset class that sucks and tell people to put their money into it. Why would they listen to you? But you can

tell them about what has worked and make a case for why it may continue and who knows. Probably not a great place to be getting your advice, but yeah there's a focus on what already happened.

Tom Mullooly: Now, Tim, you maintain our score book, so to speak and update us every couple of days on what's leading, what's not. And there have been many times where you've left my office and I'm unhappy.

Tim Mullooly: Right. So, once a week I go through our research and we have scores of how different sectors are doing at the moment. Looking at some of the numbers that we were just talking about, it kind of aligns with what we saw in the research for the last handful of years. The technology sector has been close to the top of this list in terms of relative performance.

Tom Mullooly: They been driving the bus.

Tim Mullooly: Yeah, but we've seen it start to drop down on the list, but this is, like I've been saying, this is a relative list. So it doesn't, and you can see it in the score for the technology sector. It's not, the score itself for that sector isn't plummeting. Other things are just moving ahead of it. I mean, when you're comparing different places in the market, I think it's important to just remember that it's all relative to one or the other. And it's not an absolute statement on buy this, sell this or this is working, this is not working. It's just which one is, these ones are slightly pulling ahead of the other ones, there's rotation that happens at all times.

Tom Mullooly: Okay, that's going to wrap up episode 340. We appreciate you tuning in and catch up with us on the next episode.