MANAGED ASSET PORTFOLIOS

MAP VIEWS

Second Quarter 2021

During the first quarter, stocks marched higher, fueled by trillions in fiscal and monetary stimulus and continued expectations that a post-COVID-19 economy will be a strong one. A noteworthy rotation from growth to value that began late last year continued in the first quarter of 2021. Some of last year's biggest winners underperformed during the quarter, while investors gravitated toward some of last year's laggards.

Investors continued to embrace risk. Early in the quarter, investors bid up shares of heavily shorted stocks to astronomical levels, causing massive short squeezes. Stocks such as GameStop, powered by posts on Reddit and other social media platforms, soared as individual retail investors en masse bought these shares at the dismay of several large short hedge funds. At its peak, GameStop was actually up over 1,700% year to date. As the quarter wound down, Archegos Capital Management, a multi-billion dollar family office, lost billions of dollars as their over-leveraged portfolio was forced to liquidate sizable holdings to meet margin calls. In between these events, auction house Christie's auctioned off a non-fungible token attached to a digital image for an eye-popping $69 million. Somewhere in all of this insanity, the lines between investing and speculating blurred.

Conversely, bonds moved lower as investors braced for the economic recovery and prospects for higher interest and inflation rates. Yields on the 10-year U.S. Treasury moved from 0.90% to finish at 1.716% at quarter-end. While this was a sharp move percentage-wise, interest rates are still extremely low from a historical perspective. For perspective, 10-year Treasury yields peaked in 1981 at over 15%. Just before the economic collapse in 2007, they were around 5%, and as recently as 2018, they hovered over 3%. The Federal Reserve Board has committed to maintaining an aggressive monetary stance until maximum employment is achieved (currently 6%) and inflation is above (and remains north of) 2%.

The amount of fiscal and monetary stimulus presently occurring is of historical precedence. The risk is that it continues for too long and causes inflation to grow well beyond 2 percent. While inflation has not been a word used very much for the past few decades, as we addressed in the last MAP VIEWS issue, we believe an argument can be made that the seeds for inflation have been sown. Near-term supply chain issues caused by COVID, severe weather earlier in the quarter, recent shipping delays in the Suez Canal, and a global shortage of semiconductors are combining to stoke these inflationary fears. While weather events and issues stemming from the Suez Canal shipping issue are probably just transitory, we believe the semiconductor shortage may have longer-lasting implications. Some industry experts are now calling for the deficit to last through 2022. This time frame makes sense in that it can take two to three years to construct a new fab, and demand continues to grow at a robust pace. For example, demand for computing power from artificial intelligence applications is doubling nearly every three to four months.

We continue to keep our fixed income weightings at approximately 30 percent in our Global Balanced Composite, which is the minimum permitted by the strategy. In short, we see substantially more risk for bonds than we do potential rewards. To prepare portfolios for the possibility of higher inflation, we have begun to add Treasury Inflation-Protected Securities (TIPS) to portfolios that require fixed income exposure. By doing so, we improve the portfolio's credit quality and modestly increase duration while adding a degree of protection against higher inflation. We plan on having TIPS represent approximately 5% of our Global Balanced portfolios (or about 17% of our total fixed income holdings). Currently, the breakeven level embedded in the pricing of 7-year TIPS is around 2.2%. In other words, if inflation averages less than that amount during that timeframe, then holders would be better off owning a conventional Treasury Note. If inflation averages more than 2.2%, inflation-protected securities are the better option. Given our views on the likelihood of inflation accelerating, we believe TIPS offer a more favorable risk/reward potential.

While stock market valuations, especially domestically, are elevated, we see some market opportunities while at the same time being cognizant of risks. We see opportunities in areas that should benefit from an opening of the economy and fiscal stimulus. To that extent, we have added names such as Wal-Mart and Home Depot to benefit from consumers spending their stimulus checks. Furthermore, recent additions of MDU Resources and Anglo American should perform well with increased infrastructure spending and rising inflation. In terms of risk, broad valuation levels were at record highs (even surpassing the insane levels of the dot-com bubble) heading into the beginning of the quarter. About 45 companies in the S&P 500 sold at greater than 10-times sales during the dot-com era. During the first quarter, the number of companies commanding more than 10-times sales hit 60!

Since price-to-sales is not the most frequently cited valuation statistic, quite often, we are asked, "Is that high?" Below is a quote from Scott McNealy (CEO of Sun Microsystems during the dot-com bubble). The quote was made after the bubble broke when he was asked about Sun's previous lofty valuation. “At ten times sales, to give you a ten-year payback, I have to pay you 100% of revenues for ten straight years in dividends. That assumes that I can get that by my shareholders. That assumes I have zero cost of goods sold, which is very hard for a computer company. That assumes zero expenses, which is really hard with 39,000 employees. That assumes I pay no taxes, which is very hard. And that assumes you pay no taxes on your dividends, which is kind of illegal. And that assumes with zero R&D investment for the next ten years; I can maintain the current revenue run rate. Now, having done that, would any of you like to buy my stock at $64? Do you realize how ridiculous those basic assumptions are? You don't need any transparency. You don't need any footnotes. What were you thinking?” The quote mirrors our sentiments precisely and is the essence of why we remain value-sensitive even when growth is in vogue.

We want to thank all of you for allowing us to serve as your investment adviser. It is a responsibility we do not take lightly and work diligently every day in pursuit of superior risk-adjusted returns. Stay well and stay safe.

Managed Asset Portfolios' Investment Team
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