Q4 2020 Update: The Rebound!

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Happy New Year! I think 2020 is one of those years most of us are happy to have in the rearview mirror as COVID lockdowns destroyed markets early in the year, followed by record levels of global government stimulus which ultimately fueled amazing market rebounds. If we add in political divisions, trade wars, and restraints on our freedom for the greater good, 2020 seemed like the year of No's: No school, No weddings, No funerals, No international travel, etc, etc. Despite all of this, 2020 brought many families closer together, gave us time at home to reappraise what is important, and fueled amazing adaptation and innovation. Amidst all of this, I want to thank you for your continued trust and support.

In the update below you will find the following links that will direct you to the topics and resources we have assembled for you. I hope you find it informative and useful. – Mike

Section I: Market Update

The 4th quarter was an extremely profitable quarter for our investors with value stocks outperforming growth stocks by a wide margin, so much so, that I would encourage everyone to glance through the ***MWA 4th Quarter 2020 Quarterly Market Review*** (link) slide deck. Here you will see that small beat large, value beat growth, and the Emerging Market was the highest performer for the 2nd quarter in a row. There is an investment lesson embedded in this short PowerPoint slide deck. For instance, the last 60 days of the 4th quarter illustrated that timing markets is extremely difficult. When shifts in market prices occur, much of the shift can occur in a single trading session and getting in or out in time to capture the shift is difficult, if not impossible on a consistent basis. Much of the return from major shifts in pricing will be realized by the long-term patient investors that hold steady and continue to build up positions before shifts in pricing occur. Patient value-conscious investors will continue buying and holding undervalued areas of markets because they know that prices will eventually reflect the underlying fundamentals and eventually revert toward the assets' long-term average returns. This market pricing phenomenon is called **mean reversion** and it is one of the strongest most powerful forces in financial markets. The spoils of these reversions will typically belong to disciplined, long-term tax-efficient investors that stick to their plan, not short term-traders that dance in and out.

At its core investing is really easy, **"buy low, sell high"**, the hard part is knowing where high is, and sticking to the plan when you are traveling through the lows, especially if your friends and neighbors are not traveling through the lows at the same time you are. It is even worse when the lows hang around for a long time. I want to personally congratulate my client base for their ***"Sticktotiveness,"*** one of the most difficult investing qualities to master. Over the last 12 months, as markets plummeted and then quickly rebounded you showed tremendous discipline and resolve as our investor base stuck with their investments through the painful lows, added more money near the lows, and ultimately profited as markets roared back late in the 4th quarter.   Thank you and great job!

Section II: MWA Portfolio Commentary and Changes to 2021

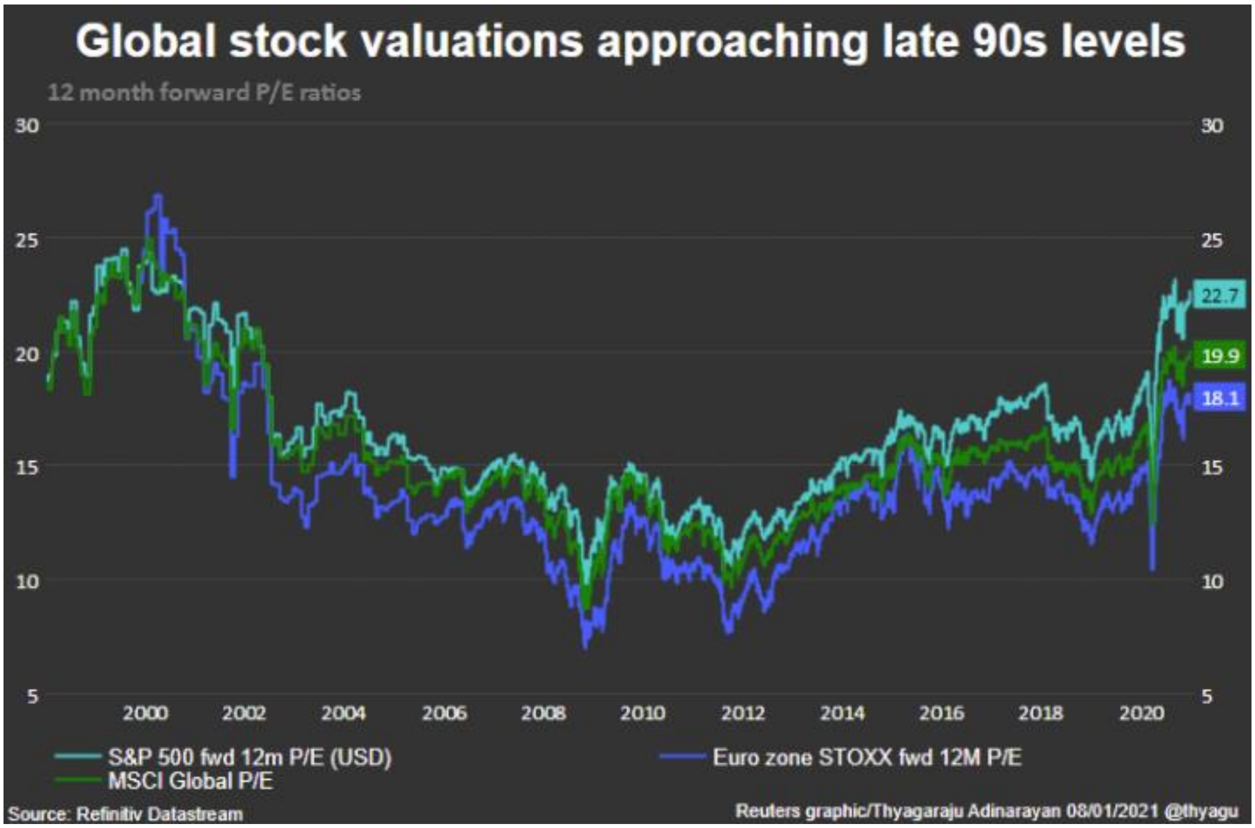
Coming out of COVID as the Republicans hand over the reins to the Democrats, markets have continued to rise on optimism of continued stimulus and more government spending programs to jumpstart the US economy. As one might expect with low rates, constant refinancing of corporate debt, riskier undervalued stocks are rebounding faster than the big companies that did not decline as much in the market pullback. History would suggest that in recessions or market declines High-Quality wide-moat companies tend to perform better while fear is high. Then coming out of recessions we often see a switch to more nimble smaller companies that have higher risk. This was what happened coming out of the tech meltdown in the early 2000s.

I want to briefly describe 3 scenarios that we think are possible are and how we may adjust the portfolios to profit from each possible outcome.

Scenario 1: The Fed successfully navigates between inflation and deflationary forces, and the markets do not crash while inflation stays in check.

This appears to be the scenario that markets currently believe is the most likely outcome today. In this scenario, interest rates are likely to stay low for an extended period probably bouncing between 0% - 1.5% on the 10-year Treasury. Stocks valuations are likely to remain elevated because they offer higher returns and better protection from bonds in a low-rate scenario.

If this is the outcome we get, I think the environment may resemble Japan over the last 20 years as developed markets muddle along. Growth will likely be slower than in the recent past as resources will need to cover debt payments before capital can be invested in productive enterprises. I think you will continue to see savings rates increase because prospects for growth are weak. Because US multinationals are trading at such high valuations future growth could be affected. Legendary Value Investor Jeremy Grantham said, "The one reality that you can never change is that a higher-priced asset will produce a lower return than a lower-priced asset. You can't have your cake and eat it. You can enjoy it now, or you can enjoy it steadily in the distant future, but not both – and the price we pay for having this market go higher and higher is a lower 10-year return from the peak."



In this world view, I think investors need to keep costs low and continue to maintain diversification. I think we want to attempt to capture profits from riskier global assets that have not run-up in price and continue to as premiums are realized and then rebalancing towards higher-quality global businesses if prices get less expensive.

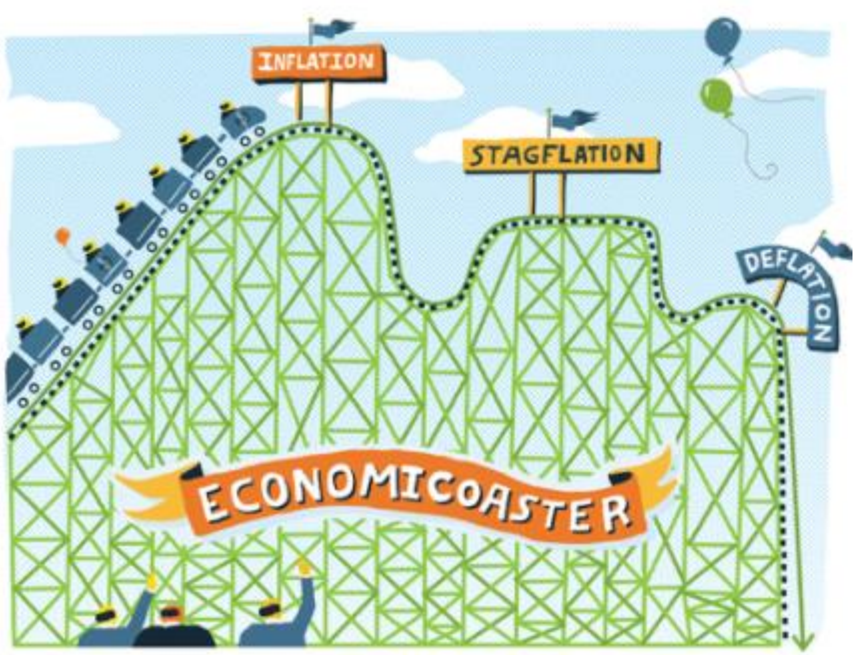
We will continue to hold emerging markets as they have better demographics, a rising middle class, and better net cashflow than the US markets. If the dollar continues to decline, owning emerging markets and emerging market bonds (in place of equities in more conservative accounts) should give diversification benefits that work if markets muddle along. On the opposite side of this trade, inside our defensive strategies, we will look for opportunities to add a portion of the bond portfolio into longer-dated government bonds when rates rise and counterbalance this with an equal amount of very short-term debt in a barbell strategy. This bond barbell should offer us opportunities to rebalance as prices and expectations move around.

Scenario 2: Inflation stoked by global money printing and currency debasement.

Mild Inflation is the outcome central banks are trying to create, however, if they overshoot the economies could heat up and rates could rise rapidly. We think high inflation is the least likely outcome of the three scenarios, but protection from inflation is very inexpensive today in the form of Inflation-indexed bonds. Because rising debt is a concern, we think it is prudent to allocate a small portion of the portfolio to profit from unexpected increases in inflation. We will look to add a little bit of gold, natural resources, and possibly Bitcoin, especially if it falls back in the below $30,000 a coin. Bitcoin despite its volatility, can be seen as a put option on continued irresponsible monetary and fiscal policy – surging in price when the extended debt cycle finally pops. We think Bitcoin and gold are compliments.

Scenario 3: Deflation or Disinflation caused from demographics and technology.
Debt growth is outpacing GDP growth, which means the best option to stabilize the debt/GDP ratio is stoking inflation. “However, in recent years, inflation has been hard to come by despite quantitative easing on a global scale: the U.S. Federal Reserve has missed its 2% inflation target in eight of the last 12 years since the global financial crisis. This seems to be brought on by an increasing debt overhang as well as the deflationary forces of technology. As Jeff Booth points out in “The Price of Tomorrow,” the easiest place to see the deflationary forces of technology is your smartphone. What would have previously been a separate collage of supercomputer + flashlight + calculator + wallet + camera + television + yellow pages + a zillion other things now fits into your pocket for prices affordable for billions. You get more for less. Many things today are basically free.”

I think central bankers are much more scared of deflation than the other two scenarios and will fight to avoid it. The best insurance against deflation is to own long duration, high-quality Treasury Bonds. We expect to keep average duration close to where it is today, however, on sharp increases in rates you may notice us moving to more of a barbell strategy as long-term high-quality bonds are still one of the best protections from deflation, disinflation, or just big market declines. If deflation does not strike this small portion of the portfolio could lose a little money, but like insurance, if deflation shows up, we will wish we had more long-term treasuries.



2021 Trading Plans:
We will maintain prior weightings away from the most expensive areas of the markets and continue to maintain exposure to smaller companies and undervalued companies that have historically rewarded investors.

If you have had outsized gains in growth stocks or the indexes you are invested in, now might be a prudent time to trim these positions and reweight your portfolio to a less aggressive overall allocation. Historically when one area of the market like oil or technology experiences rapid multiple expansion that drives up prices well beyond its long-term trend, future returns are will be lower to bring the returns in line with its long-term averages.

“In 1980 Millions of investors thought we were running out of oil. People waited in gas lines, President Carter told the American people we were running out of Natural Gas, and through it all energy prices soared as did the values of the companies that produced them. Investors stampeded into energy investments. By the end of the 1980s, 6 of the 10 largest companies were oil related, and Energy companies comprised ⅓ of the market capitalization of the S&P500. Does any of this sound familiar? Today Technology looks eerily similar (as it did in 1999) but I digress. Today Energy companies make up just 2.8% of the market value of the S&P500, the lowest on record.”[1]

“Stocks, measured by the S&P 500, returned 18.35% in 2020 and bonds earned 8.56%. Both are above their 95-year averages”[1] so being careful is the name of the game. We think investors should only take the risk they are willing to assume. Diversification will likely be our best protection in the future.

Section II-A: Bitcoin 101 Should you own it?

Over the Thanksgiving holidays, I did as much research as possible on the possibility of adding Bitcoin as an investment in our MWA portfolios. Over the past few months, several positive developments have occurred that I believe indicates Bitcoin (BTC) is not likely to fade away. In fact, I think it is much more likely that the Bitcoin network will continue to grow at a rapid pace and will be used by a wider base of consumers. Each additional consumer that plugs into the Bitcoin network ultimately gives the network more value and long-term relevance. Bitcoin, like Facebook and many other tech platforms, benefits from the network effect, and the more that use it, the more it grows in value and so on. I think one of the most positive recent developments was when PayPal began offering Bitcoin purchases and redemptions on its widely used App. This severely reduced the friction required to buy, sell, and hold Bitcoin and brought many new users to Bitcoin.

This is probably not the place to write an in-depth article on Bitcoin, I will try to get out a detailed whitepaper and links to other investment strategist opinions on Bitcoin both positive and negative, so you can decide for yourself if Bitcoin is a tool that we can use inside your portfolio. But I wanted to write a short excerpt to get it on your radar because I think the easy money has been made and it could be much tougher to earn attractive returns. I will try to highlight in bullet form some positives and negatives of Bitcoin, and why I think it may deserve a place in the portfolio at the right price, and in small amounts, but before I do let me remind you why we think Bitcoin could be a good piece of a portfolio.

As a long-term asset allocator and investment manager of managers, we do not need to win on every investment we make in the portfolio in the short run, because we are laser-focused on producing the long-term after-tax returns needed to fund the goals in our client's financial plans (paying for education, maintain standard of living, giving to cherished institutions, etc). When we build portfolios, we look for investments that behave differently from one another. Highly volatile assets, especially ones that move up and down at different times than other assets in the portfolio, can make the combined portfolio safer even though the individual pieces of the portfolio are riskier when viewed individually. I think Bitcoin (BTC) is a primary example of this. It is going to bounce all over the place, but if we use it carefully and are willing to buy more when the fear sets in, I think it is a tool that could strengthen the total portfolio especially in a situation where the developed market governments continue to print money and debase their fiat currency. We think Bitcoin is a tool we may want to include in the portfolio because governments are going to continue to print money and Bitcoin might appear to behave like an interesting complement or equivalent to commodities, natural resources, or gold.

Three Bitcoin Questions to Consider:

1. *<u>What is the price and how do you value it?</u>*

It is hard to know exactly what the value should be, but I think we can relate it to the value of the gold market and I also think it will trade on optimism based on the number of users. Today I think we are in the early middle innings, there are still more players that are likely to get involved which could drive prices higher. I think a rough valuation can be derived from Gold. If gold is worth 10 Trillion, then Bitcoin is probably worth 1/10 of that if it continues to grow. I like it at 30,000 per share. It may not get back to that price, but if it does, we will likely reach out and see about getting you some. As historian Niall Ferguson notes, if all the world's millionaires decide a ~1% portfolio allocation to bitcoin is worth the hedge, then the price per coin is ~$75,000 / coin.

2. *<u>What are the advantages of owning Bitcoin?</u>*
    - Demand is currently outstripping supply.
    - Institutional investors are getting green-lighted to invest from regulators and governments and we are seeing large institutional investors take a position.
    - Prominent money managers like Ray Dalio have shifted from being uninterested to intellectually curious and has added positions to his portfolio. The more this happens, the more it is covered in the media, the more people begin to watch and consider it as an investment.
    - FOMO- fear of missing out: As more institutional investors invest other institutional investors begin to worry about missing out on an idea that is being talked about.
    - In the past it has been difficult to own Bitcoin. More tools are coming that will make it easier and less costly to buy especially through the PayPal app.
    - Below 30,000 there are not many sellers of Bitcoin so most of the supply is coming from coins that are being mined. With just PayPal offering purchases to its network, much of the mined supply is being used by PayPal, since there is more demand from institutions, there is not currently enough supply, so prices are volatile to the upside.
    - The bitcoin network is decentralized and so far, has never succumbed to a hack.

- "Crypto is the new sandbox with algorithmically transparent rules of play. As cohorts age, more people and dollars will find themselves in the crypto sandbox."[3]
- The IRS added Bitcoin question to the 1st page. I think this is the government working with Bitcoin, not taking steps to shut it down. "The IRS asks the following question on the first page of Schedule 1 of the individual income tax return: "At any time during 2019, did you receive, sell, send, exchange or otherwise acquire any financial interest in any virtual currency?"
- "I'm bullish on bitcoin because of the unique technical properties ensuring scarcity but even more so because of the hard-core evangelical following. Many will never sell. More folks getting religion + constrained supply = a one-way impact on price."[3]

3. *__What are the disadvantages of owning Bitcoin?__*
   - A large hack that causes investors to lose faith in cryptocurrency.
   - Large players with limited oversight manipulate currency buys and sells.
   - "Bitcoin, like gold, is a vehicle for speculation. It is not a vehicle for investment, not a store of value, and not an inflation hedge. BTC is not a capital asset: it does not generate cash flows derived from economic returns on capital. Its extreme volatility invalidates claims of a reliable store of value and calls into question any inflation-hedging properties. In 2018, the price of bitcoin plummeted by 83%, while inflation expectations (five-year-forward five-year BEI) remained anchored at 2%. Then, from year-end 2018 to year-end 2020, the price of bitcoin rose sevenfold, while forward BEI ended the year again at 2%"[2]
   - Attacks from nation-states like the US (because Bitcoin takes away control of the monetary system)

Section III: Around the MWA Office

By now, many of you have met or spoken to our "newer" advisor, Jim Davis. Between Jim, Matt, Stephen, and myself we are in review season. So, look out for an email for an annual review if you have not had one in the past six months.

We are doing in person and video reviews to accommodate those who want to come into the office and those who do not right now.

If you have not had a review for a while feel free to reach out to Crystal to schedule one. crystal@millswealthadvisors.com

We are currently in the process of updating our website. So be on the lookout for that. We hope to make it easier to find what you are looking for as you are on the website and to get to the places you need such as: Charles Schwab, Black Diamond, my529, Ameritas etc.

Section IV: Videos, Podcast, & Recommended Reading

We study Billionaires Podcast – this is an amazing series of interviews There are so many great podcasts listen to it weekly, but if you just want to listen to 1 hour on Bitcoin, I think this episode is the best.
https://www.theinvestorspodcast.com/we-study-billionaires/
https://www.theinvestorspodcast.com/bitcoin-fundamentals/btc003-bitcoin-a-deflationary-world-w-jeff-booth/

Jeremy Grantham, GMO - Are we in a bubble?
https://www.advisorperspectives.com/commentaries/2021/01/05/waiting-for-the-last-dance

An Interview with Jeffrey Gundlach:
https://www.advisorperspectives.com/articles/2021/01/12/gundlachs-forecast-for-2021-the-year-of-regime-change Jeffery Gundlach is the founder and chief investment officer of Los Angeles-based DoubleLine Capital, a leading provider of fixed-income mutual funds and ETFs. In this article Mr Gundlach discusses ways to profit in 2021. I've always thought that the bond guys have to be smarter than equity managers because there is normally less upside in bonds. Mr Gundlach is extremely bright and is one of the market thinkers we follow regularly. In this article he provides interesting points that must be considered in any prudent long term investment strategy. (PDF Link)

https://www.advisorperspectives.com/commentaries/2021/01/13/us-recovery-reveals-hidden-value-in-smaller-stocks

Podcast The Bullish Case on Bitcoin: https://www.defiance.news/podcast/the-bullish-case-for-bitcoin

https://www.advisorperspectives.com/commentaries/2021/01/13/bitcoin-magic-internet-money
Commentary of the negative case for bitcoin

Jeff Booth 2 Podcast on possibility of deflation and why he likes Bitcoin.
Bitcoin Fundamentals: Episode 3 https://www.youtube.com/watch?v=XQDYMr-PMKg
We Study Billionaires: Episode 294 https://www.youtube.com/watch?v=bZ5udTPyLak

Sources:

1. https://www.advisorperspectives.com/articles/2021/01/04/the-95-year-history-stock-and-bond-returns-in-four-pictures
2. https://www.advisorperspectives.com/commentaries/2021/01/13/bitcoin-magic-internet-money
3. https://www.coindesk.com/big-reasons-bitcoin-belongs-portfolio