Fourth Quarter 2020

Quarterly

A quarterly update from The Pacific Financial Group | TPFG.com

Outlook

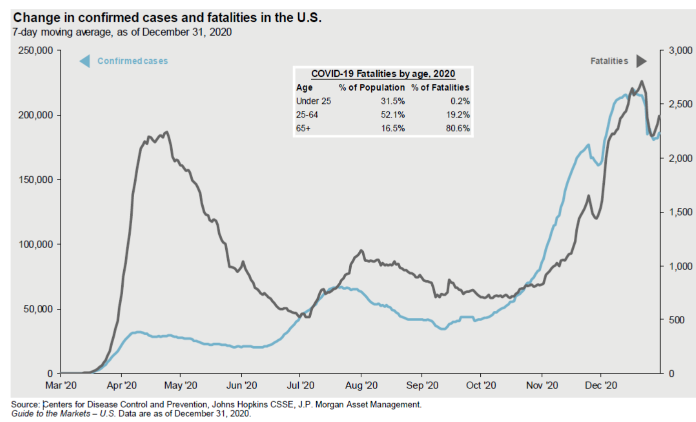
Key Points

- Strong rebound in equities
- Virus surges but vaccines provide hope
- Strong consumer poised to lead economic resurgence

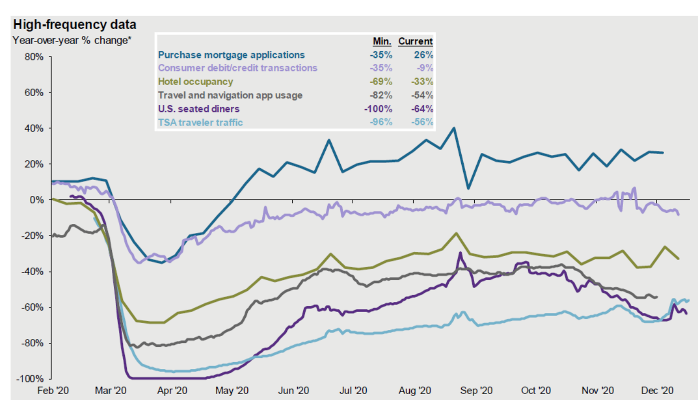
Global equity markets rallied in the fourth quarter to fully recover from the dramatic sell-off in March, with most major indices posting all-time highs. The support for risk assets was driven by an improving economic outlook and the approval of two vaccines for COVID-19. While cases have surged in the final months of the year, the prospect of widespread vaccine distribution in 2021 has investors optimistic. An additional stimulus package totaling $900 billion, which was passed at the end of December, also provided support. The relief bill provides for a range of measures, including one-time $600 payments, enhanced unemployment benefits, and loans for small businesses; it aims to provide a bridge until the virus recedes and economic activity normalizes.

We saw double-digit gains in the fourth quarter across regions and market caps, with a shift in leadership to more cyclical sectors. In the U.S., the S&P SmallCap 600 led the way, posting a gain of 31.31%, due to strength in Energy and Materials. U.S. large caps, as measured by the S&P 500, were up 12.15% and were also led by Energy. Outside the U.S., emerging markets benefited from the cyclical rotation, returning 19.70%. International developed markets got a boost from a weaker dollar and finished up 16.05%. Strong performance in cyclical sectors, such as Energy, Financial, and Industrials, pushed Value ahead of Growth for the first time all year.

Treasury yields were stable for shorter maturities, while yields on longer maturities moved higher. The 10 Year Treasury finished the year at 0.93%, rising 0.25% over the last 3 months. The Federal Reserve has indicated they expect to leave short-term rates unchanged. Longer-term rates moved higher due to stronger growth and inflation expectations. Credit sectors, both investment grade and high yield, were among the top performers as the outlook and sentiment improved.



The COVID-19 virus continues to dominate the headlines as cases surged and vaccines were approved. Both the Pfizer-BioNTech and Moderna vaccines show effectiveness of about 95% in preventing the disease in adults. Vaccinations in healthcare personnel and long-term care facility residents have already begun. Essential workers and people over age 75 will also be given priority. Offsetting the good news of the vaccines was a dramatic increase in cases, hospitalizations, and deaths. Certain regions have initiated new restrictions due to the surge; however, we do not believe they will be as severe as the March lockdowns.



Source: Market Insights: Guide to the Markets. J.P. Morgan Asset Management. Data as of December 31, 2020.

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Strategy Commentary

Overview

The fourth quarter saw a swift rally in equities across market capitalizations and regions driven by the announcement of two COVID-19 vaccines. Vaccine news vastly improved the economic outlook for 2021, driving stocks higher. Given the outlook, we made some changes to our portfolios to position for a recovery in economic activity. We will discuss the changes in each strategy in more detail below.

Balanced Strategy

Stocks rallied sharply while bonds were largely flat during the quarter. The S&P 500 rose 12.15%, while the Bloomberg Barclays U.S. Aggregate Bond Index posted a gain of 0.67%. However, there was a wide dispersion in returns within each asset class. Small caps and value led the way in equities, while corporate bonds moved higher and Treasuries declined.

We made several changes to the strategy during the quarter. In fixed income holdings, we took some profits in an investment-grade corporate bond holding and reallocated those to a diversified mortgage manager. Mortgage-backed securities, with strong underlying housing fundamentals, offer a relative yield advantage. In equity exposure, we reduced large-caps while returning mid and small-cap holdings to our strategic long-term weightings. We also shifted exposure within the large-cap space by reducing quality and defensive holdings, while increasing our allocation to large blend and adding large value. Sector holdings were shifted to take advantage of a cyclical recovery and a strong consumer, which includes the materials, leisure, and retail sectors.

The performance of fixed income holdings and allocation managers contributed to performance, while equity investments were mixed. Corporate credit and mortgage-backed securities were the primary driver of returns in fixed income holdings. Allocation managers continue to benefit from stock selection and an overweight to corporate bonds. Mid and small caps provided the largest boost in the equity allocation. Leisure and retail sector exposure also contributed to performance. Quality and defensive investments, along with home construction, detracted from performance.

Equity Strategy

Stocks posted all-time highs across most major indices with double-digit gains during the quarter. The S&P SmallCap 600 led the way, returning 31.31%. Energy and Financials were two of the top-performing sectors across all market caps. A rebound in oil prices and a steepening yield curve gave those sectors a boost. Overall, we saw strong performance across cyclical sectors as the outlook improved.

Considering the shift in the economic outlook due to the approval of vaccines, we realigned our equity exposure. We increased exposure to mid and small caps, returning to our strategic weightings, as mid and small caps tend to be more sensitive to economic activity. We expect activity to continue to improve due to additional fiscal stimulus and increased immunity as the vaccine is distributed. We also reduced our exposure to quality and defensive holdings. Risk levels had declined, reducing the attractiveness of these positions. We increased large blend exposure and added large value. We added an active manager that is focused on secular changes, innovation in technology, and innovation in health care. We expect the strength of the consumer to be a theme next year and made sector allocations to leisure and retail. We also added Materials, which tend to outperform early in the economic cycle as activity accelerates.

Mid and small caps provided the largest contribution to performance, while sector exposure was mixed, and large-cap holdings detracted. Innovation, retail, and leisure were the top contributing sectors, while home construction detracted. Homebuilders pulled back after a strong run but are well-positioned for strong demand in 2021. Defensive and quality positions, utilized to manage risk, detracted as markets rallied. A concentrated large growth manager also detracted.

Global Strategy

The MSCI ACWI Index posted a gain of 14.68%, led by Asia and with strong performance across all regions. Value topped growth, led by the Energy and Financial sectors. Emerging Markets were led by Latin America and South Korea. In addition, foreign markets got a boost from a falling dollar.

Similar changes discussed in the other strategies were also implemented in the Global portfolio. These include increasing mid and small caps, reducing quality/defensive holdings, and realigning sector exposure. We also boosted exposure to international equities by adding a global manager with a strong long term track record. Overall, the geographic exposure shifted from an overweight to the U.S. to a more neutral position. We retained a slight overweight to Emerging Markets.

Global equity managers were the top contributors to performance. Strong stock selection continues to drive returns. Emerging Markets, with a tilt away from state-owned enterprises, also contributed to performance. International equities, with a growth and quality tilt, detracted modestly. U.S. exposure was the top detractor. Mid and small caps contributed, but quality and defensive holdings detracted.

Tactical Income Strategy

The Tactical Income strategy was launched earlier this year seeking the best income opportunities while maintaining a moderately conservative risk profile. Tactical high yield strategies will play an important role in delivering on the objective. The strategy also includes a wide variety of sectors, credit quality, and maturities to dynamically manage risk while optimizing for income.

Currently, the fixed income allocation is primarily focused on corporate debt, with tactical high yield managers and investment-grade exposure. These tactical high yield managers use a range of technical indicators to determine positioning between high yield bonds and Treasuries. Equity exposure is balanced between dividend-yielding and dividend-growing companies.

We made some slight modifications to the portfolio during the quarter. We took some profits in investment-grade corporate bond holdings while increasing exposure to tactical high yield managers. We also increased overall equity exposure by adding dividend growth investments.

Fixed income holdings made the largest contribution to performance, led by tactical high yield managers. Equity exposure detracted slightly as dividend-focused holdings trailed the broader market modestly.

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The rebound in economic activity that began in May moderated somewhat during the quarter. Many high-frequency data points, such as hotel occupancy, airline traffic, and dining reservations, lost momentum as virus cases surged. Employment, which is trending in the right direction, also slowed its improvement. The rate of new job creation declined, and initial jobless claims remain elevated. One area of continued improvement is consumer economic data, including savings, wages, and debt. Total Personal Savings reached $2.2 trillion in November; this is almost $1 trillion higher than a year ago. Wages have rebounded after a sharp decline in March and are growing. Fiscal stimulus, including direct payments and enhanced unemployment benefits, have allowed consumers to reduce their debt burdens. Lower interest rates have allowed homeowners to refinance their mortgages and lower monthly payments.

A strong consumer and a rebound in corporate earnings are key to the market outlook in 2021. With the consumer generally in good shape, we expect a resurgence in economic activity once immunity to the virus is widespread. A safe environment will provide opportunities for consumers to travel, attend concerts, and go to restaurants. This should lead to a sharp rebound in corporate earnings. J.P. Morgan expects record earnings in 2021, exceeding the previous high in 2019. Energy, Industrials, and Consumer Discretionary sectors are expected to show the largest rebound in earnings, after suffering the biggest decline. However, the primary risk we face is slow progress on vaccine distribution. If progress continues to be slow, there will likely be a reluctance to reengage in normal economic activity and could cause growth to stall. Overall, we have positioned our portfolios for an acceleration of growth, but we remain diligent in monitoring a wide range of economic and health indicators to assess risk.

Sources: Morningstar, J.P. Morgan, FactSet, and St. Louis FRED

Has anything happened we should know about? If there are any changes in your financial situation, investment objectives or specific restrictions, please contact your Investment Advisor or The Pacific Financial Group, Inc. It is critical to the achievement of your investment goals and the success of our relationship to discuss any changes in your financial needs.

Our clients receive quarterly performance on their accounts. For performance on any of our strategies, please contact your Investment Advisor.

Multi-Mandate Approach

We believe that an effectively diversified portfolio should be built around three distinct mandates, with each mandate having a unique objective, expectation, and contribution to the portfolio. It is through the combination of mandates that we believe a client can experience greater diversification, improved risk management, and enhanced returns.

Strategic

The strategies offered in the market movement segment are designed to replicate the risk and return of overall stock and bond market movements. Equity investors were rewarded with strong returns due to the improving economic outlook and two vaccine approvals. Large-cap U.S. stocks posted double-digit gains, with the S&P 500 up 12.15%. Sector leadership was found in cyclical sectors: Energy, Financials & Industrials. However, investors who diversified found even stronger returns in small caps and international stocks. In the U.S., the S&P SmallCap 600 posted a gain of 31.31%, led by Energy and Materials. Cyclical sector leadership pushed value stocks ahead of growth stocks for the first time all year. Outside the U.S., both Europe and Japan had returns of greater than 15%. Emerging markets saw strength in both Asia and Latin America, with the MSCI Emerging Markets Index gaining 19.70%.

Tactical

Strategies in this mandate are designed to actively adjust asset class weightings to increase/decrease market exposure. Given the strong momentum in equities, tactical managers who were overweight stocks certainly benefited. However, sector, style, and regional positioning was important. We saw a rally in cyclical sectors, such as Energy, Financials, and Industrials, from the vaccine news. We also saw international markets outperform based on this news. These sectors and regions had lagged earlier in the year. Managers who had tilted towards these sectors posted the best results. In fixed income, credit sectors continued to outpace Treasuries, benefiting those managers who prefer corporate bond exposure.

Diversifiers

Strategies in this mandate are designed to provide a source of risk and return that is independent of overall stock and bond market movements. This is a broad mandate, representing a range of strategies with a wide dispersion of returns. The shift in leadership to cyclical sectors also impacted the performance in the Diversifier category. The rally in Industrials and Materials benefited the Infrastructure category, which was the top-performing group. Commodities were a close second due to a broad rally in commodity prices, including Oil, Copper, and Soybeans. Equity focused strategies, such as Long-Short and Option-based, also posted solid results. Market neutral managers trailed, which is expected in a rally.

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